Afraid of letting emotions drive your investments? Here's how to avoid that

NEWS

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Guest columnist

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Q: How do I avoid my emotions interfering with my investments?

A: This is such an important question! I can’t think of a more injurious issue for investors than to let their emotions take over instead of making rational decisions when making these decisions. Let’s look at this issue more closely:

Classically, we consider the most extreme and dangerous emotions in investing as either greed or fear. Greed seems straightforward — it is wanting to make excessive and rapid returns on one’s investments. This emotion is often triggered by seeing those around you seemingly making money “way too easy.” Interestingly, it is often combined with “FOMO," which is the fear of missing out.

We also see this behavior when an investment has dropped in price and the investor is just waiting for it to "come back." These two aspects of wanting excess returns are oh-so-powerful. Recall the run-up in housing prices in 2005-2008, when it seemed that you could make double-digit returns just by buying and "flipping" houses and condos.   Everyone around seemed to be doing it and making plenty of money. It was hard to resist.

The same thing happened in the late stages of the 1990s with tech stocks. At that time, companies with no profits appreciated by astounding amounts for several years. I remember hearing of 20-30% gains in portfolios per month. Those who had early significant gains due to luck in timing often become injured the most in the long term (convinced they were prescient rather than just lucky).

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Of course, both stocks in the late 1990s and real estate a few years later ended very badly for those who succumbed to their emotions. One should be attuned to feeling like you have the opportunity (or worse, the likelihood) of extraordinary gains and usually avoid acting on this perception. Seeing others making unusually easy profits should ring warning bells, not the urge to join them.

Conversely, fear of loss is a powerful emotion that must also be paid attention to. It happens every time our investments are dropping in price. When we have had very nice gains over a longer time, and just have given back *some* of the price appreciation, this can trigger the perception of loss. When this happens, we have "anchored" to the belief that all paper gains were real.

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Any long-term investor can appreciate that we have significant drops in stock market prices every three to five years, which have always eventually recovered and have been supplanted by true gains.

Investors should use this important knowledge to fight the emotion of fear and to avoid selling (and locking in lower prices) as a result. Paradoxically, dropping prices in any typical shopping venue (tuna fish at the grocery, for example) usually stimulates extra purchases. But in the investing world, dropping prices often stimulates the urge to sell.

I’d argue that a low level of fear can be a decent emotion for investing. It avoids the action of investing out of greed (or FOMO) and usually increases the likelihood of good long term outcomes. It has been said that the absolute best investments are often those that make you wary to do — but this, coupled with patience, usually wins out.

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