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Take the emotion out of your investment decisions

If the current market turbulence makes you a nervous investor, remember that a disciplined approach to investment creates long-term wealth. You cannot control the markets, but you can temper your reaction to them. We suggest that you:

- Have an investment objective
- Stick to it
- Always take a long-term view
- Educate yourself as much as possible about your investments

Behavioural finance uses psychology-based theories to explain how rational individuals fail to make rational investment decisions.

There are a number of theories that explain stockmarket anomalies and market behaviour. For example:

- **Anchoring** is when we use historical reference points to 'anchor' decisions. Investors tend to use past and most recent information to relate to future prices, making the mistake of ignoring longer-term information.
- **Regret aversion** explains how we fool ourselves to justify poor past decisions. Investors often avoid new information or concoct logical arguments to maintain their beliefs and justify past decisions. The cost of procrastination and the price of fooling oneself are equally high.
- **Overconfidence** explains why confidence in a little knowledge is dangerous. Investors often base decisions on a flawed or inadequate intellectual framework and believe they have the knowledge or expertise to predict the future. This leads to poor investment decisions based on speculative thought.
- **Herd behaviour** encourages us to conform. Investors are often swayed by what other investors are doing rather than using a rational, considered framework for decision making.

Emotions affect our financial decisions

Investor behaviour, rather than market performance, often dictates returns. But investor behaviour is not always rational. Emotions affect the financial and investment decisions that are made everyday. Fear of loss leads investors to sell investments in a panic, and fear of missing out makes investors invest in haste, regardless of the fundamental value or their long-term objectives.

In the early half of the year we experienced sharp price corrections in the equity market. The South African collective investment industry statistics show that instead of seeing this as a buying opportunity, investors withdrew a net R6.7bn from equity and real estate unit trusts, while R9bn flowed into money market unit trusts. Investors sought the perceived 'safety' of fixed interest funds, investing a further R2.4bn into this sector. In the quarter to the end of June 2008, R1.4bn again flowed out of equity funds. It is not clear whether this was sensible or not, and will not be until we have the benefit of hindsight, but is illustrative of the typical response to falling prices.

It is wise to remember that share prices are often driven high above their intrinsic value before crashing under their own weight. Sometimes it takes a turbulent period of sharp increases and declines before the markets re-establish their connection to economic and commercial fundamentals. The same is also true on the downside.

Stay the course

Studies have shown that investors are particularly bad at picking the right times to buy or sell. Selling shares that are rising in price, while buying those that are falling is rational, but difficult to implement. Investors are usually more comfortable buying shares when prices are high and rising, and selling when prices are low and falling.

Sticking to an investment strategy helps take the emotion out of your decision-making because your long-term strategy should not change when markets turn volatile. One of the worst things you can do when the market falls is take your money out of the market. This short-term strategy locks in losses and erases any hope of future gains. Changes in your personal circumstances and risk profile should encourage you to rethink your investment strategy, not short-term market fluctuations.

Attractive opportunities arise from going against the crowd

The need to conform leads to similar behaviour among people. An investor may feel it makes sense to change his/her opinion when a large majority of people are changing their views. This explains fads and fashions. Investors contribute to the very market forces that lead to inflated or deflated prices. This creates both a danger and an opportunity from an investment perspective. Unpopular shares tend to outperform more popular shares over the long term. It is thus more rewarding to stop and think than to instinctively do what others are doing. Attractive investment opportunities arise from going against the fearful or greedy crowd.

Allan Gray has a long-term valuation-based investment philosophy

Allan Gray's investment objective is to concentrate on fundamental value. In the short term, share prices are affected by market psychology. Over the long term, we believe share prices are determined by the economic progress of the underlying business. Through discipline and patience we are able to exploit the opportunities this presents. This approach is long term in nature – the investment horizon normally being four years or more. This allows sufficient time for undervalued assets to return to fair value as the market recognises its irrational pessimism.

It is difficult to own unpopular shares that continue to fall in price in sympathy with unfavourable short-term prospects and even more difficult to buy more of them. This is however, when we get most excited as we know we are able to accumulate shares that are being sold at prices that will deliver exceptional future returns.

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