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Investment decisions & emotions… not mutually exclusive

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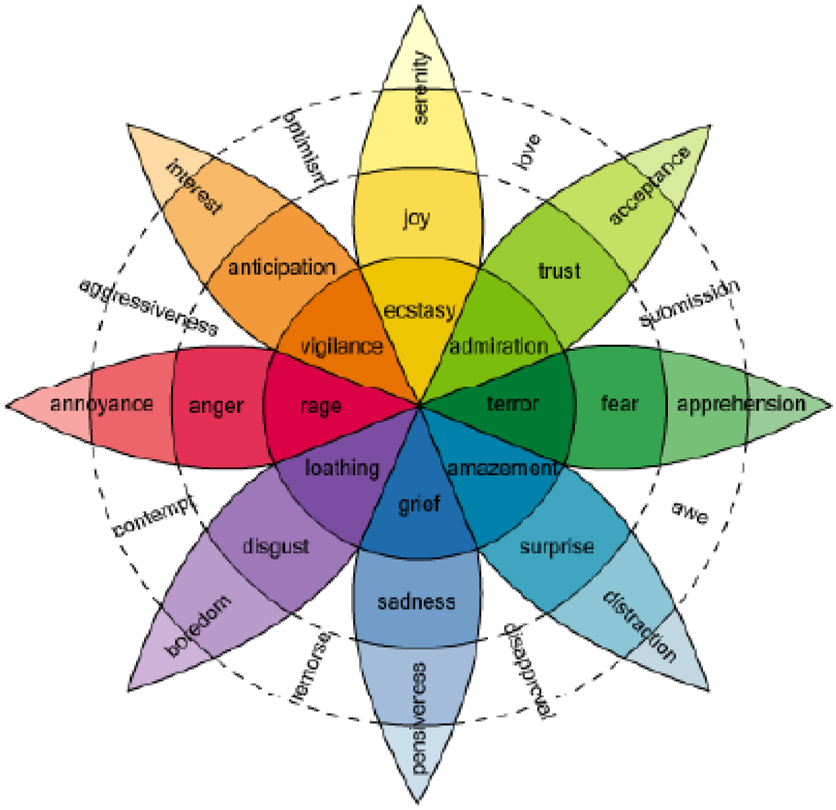
The conventional or classical theory of finance assumes investors are rational, unbiased, and act robot-like or emotionless to maximise their investment benefits. From this perspective human emotions are seen as a serious impediment or weakness in fulfilling this objective. Thus, according to the theory, one could argue that a successful investor is one that can make decisions without emotions unduly affecting the quality of decision-making (investing).

But it is not that simple…because it is not possible to be human without emotions consciously or unconsciously affecting decisions – in fact, as will be seen a bit later, it is not possible to make pertinent decisions without experiencing emotions.

What are emotions really? First of all, it is difficult to formulate a strict definition thereof because it has a cognitive, physiological, social and behavioural aspect to it. Emotions are more than just "feelings" and are evaluative rather than pure bodily sensations. It may not have a cognitive basis at all – roses smell good…well, because they smell good. Emotions are evaluative in that positive or negative "scores" are attributed to objects or states – from unhappy to happy or pessimistic to optimistic, etcetera.

Emotions are caused by people, objects and situations. Such emotional experiences are stored in the pre-frontal cortex of the human brain and are part of the unconscious section of the human brain that may override the higher conscious functions. It is important to note that it can be consciously or unconsciously experienced or interpreted and will lead to action tendencies. Emotions evoke physiological reactions, specific cognitions and subjective feelings.

Plutchik's Wheel of Emotions



One can identify eight base emotions, which are common to all humans and many animals that can be organised in four base pairs, namely *anticipation* versus *surprise*, *joy* versus *sadness*, *trust* versus *disgust* and *fear* versus *anger*. Different higher emotions are possible as combinations thereof.

Fear and *greed* are well-known strong drivers of investment market behaviour at times. Other emotions investors typically will experience include *regret*, *risk-aversion*, and "safety in numbers" (*herding*).

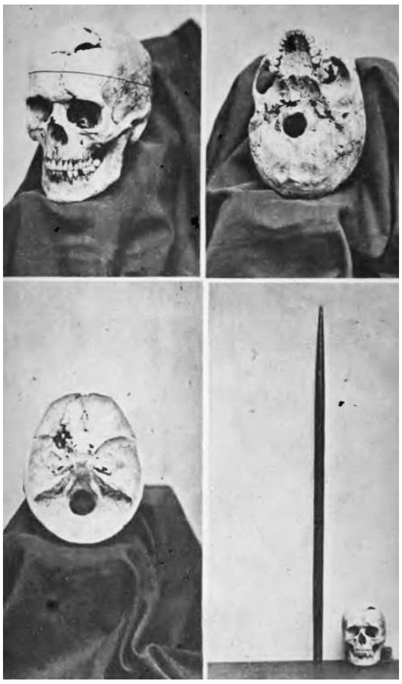
But, of course, emotions are not only responsible for sharp market corrections, but also the formation of price bubbles (irrational exuberance) when market participants by large ignore fundamentals or sound investment principles and follow the herd in anticipation of super-sized profits to be made.

Heightened emotional states often lead to some adverse financial outcomes. For example, angry or excited people often act contrary to their economic interests and make irrational decisions, i.e. disinvesting from the stock market <u>after</u> it crashed, or over-investing in particular expensive sectors of the market that have done exceptionally well in the recent past.

Typically, in states of arousal the future is discounted much more than in relaxed states, i.e. strong preference is made for the present (known) state rather than the prospects somewhere in the (unknown) future. Also, higher perceived probabilities are attached to the occurrence of unlikely (extremely bad or good) outcomes than an objective analysis of such events would imply.

The Phineas Gage saga…

Phineas Gage (1823-1860) contributed enormously to our understanding of the physiological working of the human brain. But no, he was not a famous neurologist or scientist at the time, but a modest railway worker that miraculously survived a rock blasting accident in 1850 when an iron rod that was thrown up in the air by the blast, penetrated Gage's skull as it came down. Gage somehow survived the freak accident and recovered fully…well, at least in appearance. The iron rod, in fact, destroyed his pre-frontal cortex, the area of the brain that control emotions. Gage, for all practical purposes, became a different personality all together - a human being without any emotion. How did Gage cope after the event? The odd situation was that while Gage did not have problems interpreting information, he could not readily make decisions anymore, or there was no real sense of urgency to make decisions because of the absence of emotions.



Source: Wikipedia

Afterwards, numerous studies on brain-damaged patients with impaired emotional responses, found similar tendencies. Ground-breaking research, for example, that of Demasio (1994) indicated that decision-making is inter-twined with emotion. For example, patients with damages to the prefrontal cortex, but with unaffected knowledge, attention, memory, and abstract problem-solving skills, found it very difficult to make decisions, plan a course of action, plan for the future or recognising undue risks/dangers that required a change of behaviour.

The evidence…

The evidence from neurological studies thus far led to the conclusion that emotion and reason are part of the human organism – “one cannot separate the mind from the body”. Moreover, emotion actually improves decision-making in two respects, namely focusing individuals to make a decision when it is paramount, and helping them to optimise decisions. While strong emotional responses (especially negative feelings) are not likely to contribute towards sound financial decisions, the total absence of emotions is not helping either. It seems that “positive feelings” is the missing link in so far it is then easier for the human brain to process information; and it enhances the problem-solving and creativity skills of the human brain.

An investors' guide dealing with emotions

Thus, contrary to the somewhat popular opinion emotions *per se* do not lead to suboptimal financial decision-making; it is part and parcel of the human condition and may actually enhance decisions. But, there are a few situations, like stressful or panic states, emotions are unlikely to help investors. Thus, what can investors do to help them through these rough patches?

First of all, have clear investment goals. Many investors think they have an investment plan, but the soundness thereof is tested only during crisis periods. Or, as the notorious boxing champ, Mike Tyson once remarked: All boxers have a plan until they get hit! For example, what is the specific purpose of the investment and appropriate investment horizon that in turn will determine the most suitable investment strategy? If one is saving for retirement in, say, twenty years' time it is definitely not necessary to get upset by the latest market volatility and therefore changing one's investment strategy when dark clouds are gathering above investment markets. Even retirees should maintain a longer term investment horizon for some part of their investments, after providing for immediate and near-term income requirements.

Secondly, understand your investments – although it is not necessary to have a complete knowledge of all the technical investment detail, a basic understanding of the major drivers of market returns, and expected market volatility will suffice to prepare one for those times one's investments are not performing in line with expectations. At the minimum, understand that risky investments will not yield straight-line returns year after year. Basically, the notion "average return per annum" is not implying that those returns will be attained each year, below-par returns are bound to happen from time to time.

Thirdly, while it is natural that one wants to know constantly how well one's investments are doing, a great risk exists that one will make undue changes to one's investment plan based on relatively short-term (below-par) performance trends. Know the reasons why you have made the investment, your expectations at the time, and possible downside risks. Preferably write it down, i.e. keep an investment diary that will serve as a mental reference when market conditions are perhaps not favourable at certain times and you are struggling to understand why you have made those investments in the first place. Also, an investment diary kept over time will reveal just how dynamic and unpredictable market conditions are in reality.

A simple foolproof strategy that one can use to reduce emotional and behavioural investment mistakes is to invest on a regular basis (rand-cost averaging). Most investment products (unit trusts and ETFs) facilitate debit order investments. Over time these regular contributions will become part of one's monthly expenses budget, i.e. one is investing without consciously thinking about it all the time. A huge additional benefit is that distributions (dividends and interest) can be automatically re-invested to acquire more shares (units).

Finally, at all times employ a diversification investment strategy; both across and within asset classes (stocks, property, bonds and short-term interest investments). Too many investors are making gross investment errors by over-investing in particular "hot" sectors of the market while ignoring the price they are paying to acquire those assets. In fact, the primary motive is the firm belief there will be a next person willing to pay even more (also known as the greater fool theory).

Probably one of the most important investment lessons for investors is that the actual investment returns one will achieve over time is more determined by the initial price one paid for the asset than the perceived quality of the asset versus other assets, i.e. it is not to say that because Firm X is perceived to be of better quality (management, products, financial status or fundamentals) than its competitors, it should therefore outperform all its competitors over time, i.e. a good story is not necessarily equal to good returns. Alternatively, one could argue that the perceived advantages of a firm relative to its competitors are most likely already included in the price you pay today.

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