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SURVIVING EMOTIONAL INVESTMENT MISTAKES

Recognizing damaging biases and pitfalls is not as easy as it sounds. It is a daily challenge as different sets of circumstances and experiences trigger unique propensities within a person.

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MENTAL MINEFIELDS AS A HIDDEN ENEMY

Emotional reactions and biases of investors can frequently create mispriced stocks. Mispricing either creates attractive buying opportunities or is worth avoiding ahead of price drops. Recognizing damaging biases and pitfalls is not as easy as it sounds. It is a daily challenge as different sets of circumstances and experiences trigger unique propensities within a person.

Inconsistencies in processing information, self-deception and raw emotions are all part of human nature, as are erroneous assumptions, biases, anxiety, fear, greed, excitement and despair. These, coupled with the inherent volatility of stock prices, spark our reflex reactions and fog us from an informed logical perspective. Hence, it is not easy to detect these mental tricks and biases.

It is critical to not let these emotions dictate poor decisions or shortcuts. Solving an investment puzzle without having all the pieces not only requires a consistent approach, but also continued risk analysis and self-awareness. Risk simply means less certainty in an outcome down the road. While companies and their management teams entail risks, the most easily overlooked risk of all is our own tendencies and habits of processing information.

History is littered with examples of self-destructive behaviors. Banning all emotions to become completely detached before making a decision is nearly impossible. Yet, the best investment decisions tend not to be emotional reactions. Better self-awareness can be the starting point to preventing unacceptably low returns or even loss of original investment.

Self-realization can even aid in more frequent participation of profitable investment opportunities. Being able to pinpoint particular behaviors, displayed or subconsciously present, will also propel selling losing stocks with less hesitation while even retaining real winners longer.

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“If I had never owned this stock, would I buy it today?”

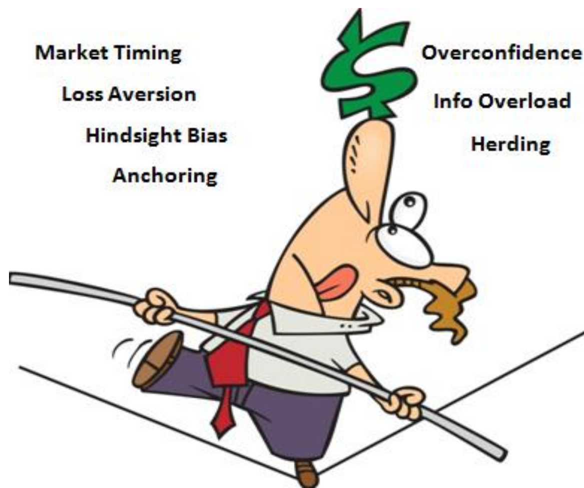
The Most Common Pitfalls and Traps

Trying to Time the Market: Habitually pulling money out of the stock market and then putting cash back in later is a risky tendency. Missing out on the 10 Best Days in the market can cost 4% each year. Not participating in those 10 Best Days each year can lead to passing up nearly HALF the historical average annual total return of the stock market. Self-defeating panic causes some investors to sell near the bottom without a chance to participate in a pending rally. The “no pain, no gain” adage holds true during volatile markets. Price swings and periodic economic jolts are often unpredictable in the near-term. Even media and unrelated events can overshadow the underlying progress at a good company. Positive catalysts take time to come to fruition and there will be periods of no news. Stocks can still perform well on the back of no news.

Loss Aversion and Regret: Studies show that an investor feels at least twice as much emotion for a loss of the same magnitude as a gain. Waiting for the “bounce back” in stock price to recoup a loss (“breakeven” mentality) is refusing to exit a losing position due to being overly optimistic of a rebound. Studies also unfortunately show that investors are 50% more likely to sell winning stocks (ones with high unrealized gains) than to sell losing stocks (ones with losses) – which is a top reason for underperformance from wrongly exiting the stars and instead keeping the decliners. This even triggers capital gains taxes.

Along similar lines, while regret is often reduced by rationalizing that the stock has a high dividend, this too can be a trap that prevents selling a losing stock. What matters most is what the stock is worth today on future prospects! Ignoring the original purchase price will lessen the stubbornness to sell. Negatives should not be overlooked but instead weighed against positives. A company’s outlook and prospects can change dramatically during your holding period. A good way to re-approach it is by asking, “If I had never owned this stock, would I buy it today? Are the fundamentals as attractive as they were on my purchase date?” If not, it is probably worth selling if its prospects or thesis has deteriorated. It can always get worse, so cut spiraling losses earlier on. A decision like this can be uncomfortable, but rewarded later with a better investment opportunity.

Confirmation Bias: Disregarding facts or evidence that does not support your opinion or theory is a frequent mistake. This dismissive tendency of ignoring data contradictory to our view can cause prolonged holding onto losing stocks or buying into problematic ones.



Rather than recognizing the eroding aspects of the company or industry, preconceived opinions interfere and mask red flags as we only look for information that agrees with our stance. This bias often occurs when "two cooks are in the kitchen" (husband and wife or two portfolio manager teammates) sharing the same lopsided views on a company. Instead, try not to skip negative evidence. Consider the red flags mounting rather than one-sided skewing of only positive "confirming" information.

Herding and Following the Flock: A "herding" mentality stems from being overly influenced by the actions and views of others, such as hopping on trends or prevailing winds due to peer pressure for blending in with the pack, as when your neighbor was getting rich by buying technology stocks in 1999 or real estate in 2006. Hearsay is no substitute for research. Stories can seductively overwhelm evidence, causing investors to less knowingly overpay for higher-risk companies that really should only be bought at a lower entry price. Bubble-riders typically end up regretting their "ride the rocket" flight. Stocks can quickly become overvalued with too many investors quickly chasing them. Often enough, excess optimism drives the stock price up and not its fundamentals or prospects! On the flip side, premature selling of a stock due to peer pressure can be an unwise decision. Instead, have a sound "mental checklist" to consider if this company's story makes sense. Is management capable? Is this an enduring growth trend? Is valuation reasonable? Ask the pertinent tough questions and avoid the herd.

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Hindsight Bias: A very common syndrome of thinking we were aware of the outcome before it occurred. This is a "looking back" predictability flaw, "I knew it all along" or "that was obvious" or "I told you so!" attitude which overstates the predictability of an event. This post-rationalization overinflates one's ego. It can also be an excuse for not having taken any action. Hindsight is always 20/20. Documenting decision rationale before making the choice will help avoid fabricating this alternate mental version.

Concentrated Positions: Diversification is important for long-term success by not putting all your eggs in one basket. Variety and consideration of risk tolerance improve investment returns. Avoid concentrated positions (more than 5% in any individual holding except for cash/money markets) and be mindful of large stakes of employer stock. Using "incremental" additions to a buy (buying a new stock in 2 tranches several months apart) reduces your risk (in case price drops from your first purchase) and also improves your reward potential.

"The inability to form decision conviction leads to avoidance of making any choice."

"Overconfidence can also act as a defense mechanism giving a false sense of forecasting ability."

Chasing Returns: A classic case of the tail wagging the dog as more money goes after the same investment, which produces diminishing returns to late entrants. The opportunity becomes "too crowded" and far too easy to be late to the party for higher flying stocks, especially if growth expectations are re-based downward shortly after the stock is purchased. Conversely, for more attractively valued stocks with sustainable prospects, "dollar cost averaging" into a new holding (incremental steps buying) could help prevent purchasing near a peak price.

Procrastination and Paralysis: Avoiding an important choice is still a choice! When failing to act on a sell or buy opportunity, motivated forgetting or ignoring ensues. Decisions are not needed every day or week. There is a "zone of inaction" (no action necessary on holding) warranted if you have done your homework and the thesis and market fundamentals are still intact. But avoiding a fear-induced coma for decision-making will be beneficial at inflection points. Moreover, people generally fear what they do not understand. So, they can be prematurely dismissive or led astray. The inability to form decision conviction leads to avoidance of making any choice. One way to offset this pitfall is to set aside adequate time to properly and thoroughly research a stock candidate. Then, an informed decision with proper perspective can be made.

Overconfidence and Ego: Overestimating one's abilities is rarely beneficial; neither is investing in a company one does not understand but thinking others understand it well enough to justify its high stock price. Even overestimating the likelihood of an event and neglecting to incorporate the "bad result" probability before making your choice is a trap. Confidence does not lead to improved accuracy or correctness in many cases. Money is an ongoing emotional subject for most people, causing urges to prove a superior ability to yourself or others. Overconfidence can be fueled by greed as common sense is tossed out the window to instead feast on unrealistically high expectations. It can also act as a defense mechanism, giving a false sense of forecasting ability. By not acknowledging a mistake, one usually does not learn to avoid repeating it.

Attributing Skill Instead of Luck to Success: Portfolio managers do not go from dummies to geniuses overnight or vice versa. There will always be a random element or force in the stock market outside an investor's control. Just because your stock went up does not mean it was a correct decision – markets tend to rise over time anyway! Boldness with risk neglect can haphazardly produce good returns, but will not serve as a long-term winning strategy.

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Even your sense of "familiarity" can wrongly be substituted for knowledge and experience. Confusing familiarity for expertise leads to the illusion of comfort and letting your guard down.

Anchoring and Recency Bias: Initial beliefs are overly anchored to a narrow set of information and can be too heavily relied on in a decision. The more recent the event or experience, the more prone you will be to put extra emphasis or weight on it. Recalling past events inaccurately (downplaying shortfalls or overplaying decent results) with the hope of looking smart can be an excuse for not acknowledging mistakes. The more a stock goes up, the more we like it. The more it goes down, the more we dislike it. We too often allow the price to dictate its true worth. Instead, we need to do our own logical homework.

Information Overload and Forecasting Reliance Danger: Only enough information is needed to make an informed decision. Being inundated with too much data can derail you. Accuracy diminishes when too much time is spent forecasting and not enough time is spent focusing on the big picture and thesis drivers. It is natural to want reassurance for big decisions, but too many viewpoints and contradictory ideas will counterproductively impair decision making. Failure to buy or sell a stock (inaction) can occur if overloaded.

Media Circus: One day it is euphoria and bliss on television. The next day it is apocalyptic doomsayers. The media is paid to grab viewers' attention spans by offering extreme cases of everything. Try not to drink from the fire hose. Those sources are biased and cherry-pick their favorite couple of factoids out of dozens available each day. Not everyone is a guru or a pundit. Talk shows need to make even the dullest things seem exciting to lure viewers in with fear or joy to boost their ratings. These shows pressure you to trade into and out of the market. It is best to tune out the distraction and filter out daily headlines to avoid undue trading expenses and missed opportunities.

Being Myopic: Looking for a quick gain over the next 3 months is not investing. Listening to a "hot tip" from a friend, co-worker or neighbor should never be acted on right away, but instead thoroughly researched with the same amount of time you would if you found the idea yourself. No cutting corners! However, there will also be times you need to resist selling out of a stock – namely when bearishness is near an unwarranted extreme level.

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Doubling Down on a Loss and Roundtrip: the impulse to throw more good money after bad intensifies after a loss occurs.

Selling now and redeploying those proceeds into a better opportunity tends to be more successful than doubling your share count by buying more after a large drop due to eroding fundamentals. Investors often do not have an exit plan and instead hold a stock until valuation is stretched or a negative catalyst occurs, forcing the stock price back down to their purchase cost (roundtrip).

Play Money Mindset = Speculation: All amounts of money should be treated prudently. While you might have a sliver allocated to "higher-risk" investments, you should not take the stance at the outset of investing that you are willing to lose it all. Instead, thinking about "upside" versus "downside" (potential percentage gains or losses) will keep one from overpaying for too much negative asymmetric risk.

Key Takeaways

Emotions should not be the guiding force in decision-making.

Most stocks advance by exceeding expectations or improving prospects of their future cash flows. However, perception of a stock by others can be as powerful or as dangerous as reality. An investor needs to anticipate the expectations of others and remain alert that emotional biases often misprice a stock (overpriced or underpriced). Emotions should not be the guiding force in decision-making. They can lead to obsessing over negatives or losses, which in turn causes you to miss out on a profitable upcoming opportunity, even cause the extremes of being gun-shy or overconfident. Panicking works wrongly both ways – rushing to get in after stocks took off upward or heading for the door shortly before the correction is over. This is a large disservice to you and prompts rash choices. Rationalization, by inventing excuses, is an instinctive reaction from egotistical or less logical investors. It is a humble wake-up call to recognize that biases are naturally abundant and we need to prevent being tricked by them. Investment returns can improve by overcoming these identified damaging tendencies. Most are not aware of these roadblocks. Professionals can be "designated" drivers to maintain objectivity and help navigate these emotional investment minefields.

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