



Corporate Authorised Representative (No.319641)
of Wealth Leadership Services Pty Limited
ABN: 36 121 535 993 AFS Licence No. 317369

Level 12, 95 Pitt Street Sydney NSW 2000
GPO Box 2008 Sydney NSW 2001
Telephone: 02 8249 8176 Fax: 02 9247 5797
Email: general@wealthfoundations.com.au
Web: www.wealthfoundations.com.au

Fortune favours the Brave!

If you're feeling pretty uncomfortable about the current state of financial markets you can be reassured that you're not alone. Almost all investors are experiencing some discomfort from the recent falls in asset values, yet some handle it better than others.

How you manage your emotions in relation to the market's volatility can have a big influence on your investment outcome over the long term.

In this article we explore the influence of our emotions on financial decisions and look at what we can do in times like these.

Our emotions are fundamental in the decision making process and influence our behaviour, thoughts and actions. Understanding our emotions and learning to manage them can improve our overall investment experience.

According to studies by behavioural scientists¹, our feelings make us focus on information that matches our mood. So, for example, if the market is trending upwards, and your mood is positive, you would tend to focus on information that confirms these emotions, (as was probably the case throughout the first half of last year). Conversely, **we are more likely to be influenced (unconsciously) by information that is negative** in the current climate.

Our feelings also influence what information we retrieve from our memories. For example, if you are in a positive frame of mind, you are more likely to focus on positive possibilities. Given the current sentiment, **we can assume that most people are currently focusing on negative possibilities.**

These reactions can spiral and feed off themselves. Once a market starts to rise, our mood improves – our focus shifts to positive possibilities and positive news. As a result, our mood improves further, which in turn focuses our attention on more positive news and even more positive possibilities. If our emotions can spiral, upwards or downwards, then **our emotional projection of the future possibilities for market prices can end up being either euphoric or cataclysmic.**

¹ "The impact of emotions on probabilistic decision making", Dominique Cappelletti, August 2005

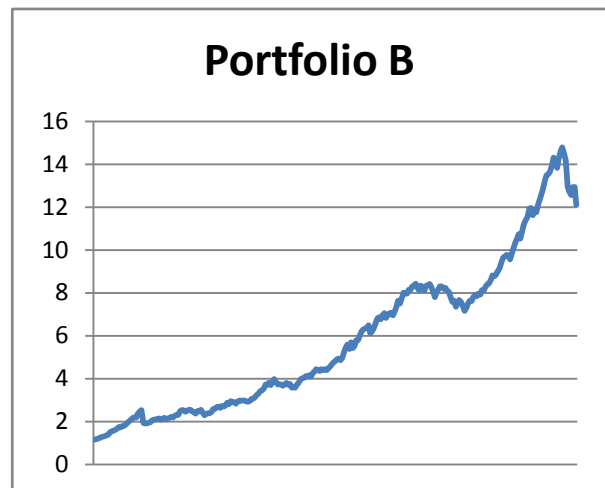
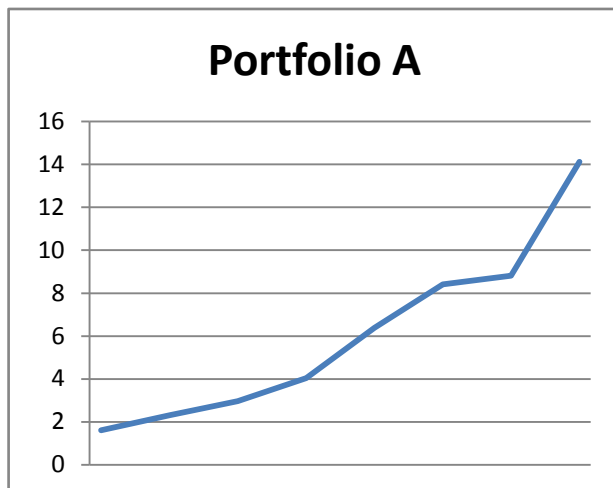
With the benefit of hindsight, it is apparent that most market highs are experienced when emotions were excessively optimistic and market lows experienced when emotions were excessively pessimistic. Based on this observation, **investing when you feel optimistic and selling when you feel pessimistic is unlikely to prove a smart investment strategy.**

Yet emotions do have their place in the decision making process. As one behaviouralist noted, “if you were a small animal faced with a bobcat and had to make a deliberate decision about what to do, you would have to consider the likelihood of each possible choice succeeding or failing and could get so bogged down in decision making that you would be eaten before you made the choice”.

However, financial decision making is not of a life and death nature, (even though it may feel like it sometimes). **Our emotions help us take action and avoid procrastination**, yet we need to temper them to avoid being reactive and falling hostage to them. Instead, our aim is to balance the emotive need to act with our long term requirement to make smart financial decisions. You can do this by “stepping back” and reappraising the situation from a more rational and unemotive perspective.

Generally, **the broader the perspective you take, the smarter your decisions will be.**

Consider the following two portfolio performances:



Which would you have preferred to have invested in?

The fact is that they represent exactly the same portfolio. Portfolio A is simply valued less frequently than Portfolio B. Portfolio A is valued once every three years (as may be the case with a direct property exposure), while Portfolio B is valued every month.

Many people feel more comfortable investing in direct property rather than shares. This is often due to the lower apparent volatility of property values. However, much of this is an illusion created by the (in)frequency of valuation. Imagine valuing your property every day according to what someone else was prepared to pay for it and only valuing shares once every three years. It's likely that your perception of the risk for each would alter considerably.

We can learn from our experience with direct property ownership and not get too caught up on the short term 'noise' of the share market. This 'noise' is a function of the frequency of valuation (which is an outcome of the superior liquidity of shares). It can however create more emotion than you need. **Just because you can value your portfolio every day doesn't mean that you should.** Step back and take a longer term perspective – it will help you make smarter financial decisions and become a more successful investor.

Focusing on getting the facts, not opinions, will also help to reduce the emotion in your decision making.

Consider the old share market saying, "the market goes up by the escalator and down by the elevator". Most people are wary of the risk of a sharp fall in their portfolio but have not considered the market's ability to rise quickly. We ranked the performance of the share market in terms of best and worst monthly returns since 1980.² The worst 30 monthly returns averaged a fall of -8.39%. Not pleasant, yet this was lower in magnitude than the rises of the best 30 monthly returns which averaged 9.6%.

Markets can rise quite quickly – quicker, on average, than markets fall. As with market falls, these rises occur without any warning, and often when least expected, and can leave those insistent on waiting for the 'right' opportunity with the risky dilemma of how to get back in.

In addition, **shares rose almost twice as often as they fell** over the 342 month period. And, when compared to cash, the return of shares was, on average, higher than that of cash for seven months of every year.³

Most people need to take a certain level of market exposure in order to meet their long term objectives. If markets rise in more months than they fall and their average monthly rise is higher than their fall, then there is less risk in being invested in the market than being out of it.

So, what can you do in times such as these? The best approach is to maintain a constant exposure to investment risk. In fact, this is recommended throughout all market conditions. In applying this approach you need to work on tempering your optimism during the "good" times and strengthening your conviction during the "bad" times.

In order to participate in the long term uptrend of capital markets you need to understand and practice managing your emotions. This requires discipline, perspective and courage and those who display these characteristics make smarter financial decisions and reap the rewards that elude the average investor.

² As measured by the S&P/ASX 300 Accumulation Index

³ Shares as measured by the S&P/ASX 300 Accumulation Index and cash as measured by UBS Warburg 90 Day Bank Bill Index.