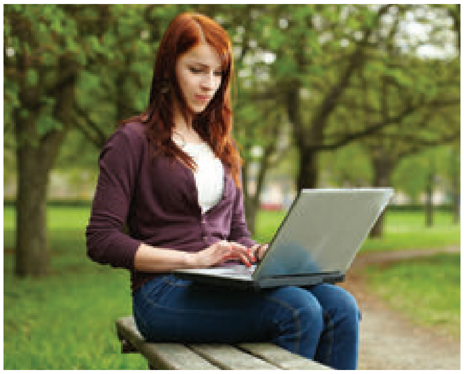
SPECIAL REPORT

Investor behaviors

The "Don'ts" of Investing



Artificial intelligence may be able to react logically and rationally in any situation, but most people can't say the same. Unlike machines or robots, we are real people who react with social, cognitive and emotional biases, like when it comes to investing money in the market. Because these biases lead to behaviors that tend to be systematic, we can analyze and learn from past mistakes to avoid negative behaviors when it comes to our own investing.

Confidence

How do you rate yourself when it comes to investing? Confidence is a great trait, but too much or too little of it can be bad. When it comes to investing, overconfidence can lead participants to focus only on the upside and to underestimate the possibility of poor performance. A lack of confidence can lead participants to be more conservative in their investment choices relative to their age and investment horizon. These confidence perceptions can lead to poor investment decisions.

Hindsight Bias

If participants were psychic, investment portfolios would surely look very different. For example, if you believe that a negative investment event may occur and you react, then you may feel anger or regret if your prediction was incorrect and instead had a negative impact on your overall investment strategy. Beating yourself up over an unexpected outcome or an error in judgment can lead to irrational future investment decisions. Trying to foresee outcomes that are impossible to predict only wastes time and frazzles nerves.

Short-Term Focus

Are you online checking your portfolio performance daily, noting every daily market fluctuation? Today's technological advancements make it easy for participants to constantly monitor investment performance. It is always recommended to regularly evaluate a portfolio to be sure it is achieving its goals. Constant scrutiny, however, could lead to short-term investor behavior such as frequent trading. If your retirement is 30 years away, for example, your portfolio is designed to be able to withstand typical daily market volatility. Remember, daily fluctuations are not necessarily indicative of long-term performance. Try to resist the urge to act upon short-term volatility.

Regret

Participants sometimes regret making an investment decision that did not go as expected. Unfortunately, this is part of investing. Some participants, however, allow this regret to alter their investing behaviors. Some may become risk-averse, feeling if they "play it safe" they can avoid negative outcomes. Others may actually take on more risk, thinking it may be necessary to reach their investment goals. Sticking to your long-term investment strategy helps avoid either error.

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Mental Accounting

Asset allocation and diversification can help to balance a portfolio's performance. If one type of investment performs poorly, another could be performing well and counter the negative results. Mental accounting is when a participant compartmentalizes investments and ignores the portfolio as a whole. In other words, a participant may place different subjective values on money depending on the type of investment the money is allocated. Such a narrow perspective could lead someone to overlook various asset classes. Asset allocation and diversification, however, cannot assure or guarantee better performance, and cannot protect against loss in declining markets.

Hot-Hand Fallacy

Investing certainly would be easier if there were patterns and trends to follow. For this reason, some may see a pattern where none exists and take action based on this perception. Participants may want to chase the "hot" returns assuming they will remain positive or even select a "hot" manager who happened to have a good year. Unfortunately, these may not be the best strategies when it comes to managing a portfolio. Short-term performance is not a true testimonial of long-term performance.

Negative investor behaviors can be quite damaging when creating and managing a portfolio. By identifying and understanding these behaviors and misperceptions, you can avoid making similar mistakes. A basic investment education, a properly constructed portfolio, and clear objectives can help in sticking to the proper investment strategy.

Source: Morningstar

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