

Don't panic. But watch out for behaviours that could threaten your financial security.

"Fear is a great motivator – but a bad guide. A better strategy is to stay calm. People who act coolly will make better decisions than those that act emotionally."

For most investors, recent market volatility has resulted in heightened anxiety and concern. While we believe that risks do remain in what might ultimately go down as one of the most significant crises in financial markets history – it is clear that many investors are being guided by an unprecedented level of fear and emotion. In this edition of *Investor*, **Chris Corneil** outlines some of the common pitfalls that lead to harmful investment decisions and explains that the most important variable in your investing success – and the only thing you can control – is your behaviour.

Common behaviours that threaten financial security

We're all emotionally involved with our money at some level. Nobody is immune to factors that influence behaviour. Fear, greed, indecision and regret are the emotions most frequently linked to harmful investment decisions. They all render people susceptible to a variety of pitfalls.

In the case of planning for your future, there is at least one tendency that we've all succumbed to on occasion. It's the feeling of instant gratification that causes people to **overemphasise immediate rewards** at the expense of long-term needs. It's very easy to make a decision today about your investments without comprehending the long-term opportunity cost of that decision. We often assume that long-term financial commitments can be put off for another day. But in reality the earlier you act, the more options you are likely to have when you reach important life milestones.

You may recognise your own past decisions in a handful of other frequent behavioural tendencies.

Naïve diversification is a frequent contributor to unnecessary risk. This is typically the outcome of dividing money based on rules of thumb without evaluating risk tolerance or return expectations. The classic case is holding several managed funds without understanding the overlap in them and the lack of true balance across global asset classes. As an example, you may invest across several investment managers, but if their underlying investment processes are similar have you really got a diversified portfolio?

Overconfidence in our prowess as market prophets can also be detrimental to making market profits. When markets advance enough to get the casual investor's attention, investors often start to think their success is the result of skill, rather than cyclical luck. And sometimes, **belief persistence** causes us to ignore evidence or indicators that are contrary to what we may believe to be in our own best interest.



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Another contributor to financial difficulties is the tendency to **overweight recent events**. It causes misguided decisions at both good times and bad, as fear and greed override long-term prudence. It's reactive, not proactive, and the response often causes people to buy high for greed's sake and sell low out of fear. This is why some investors move in and out of their investments at inopportune times, mistaking growing value for risk and vice versa.

Investors often also fear loss more than they seek gain. **Loss aversion** makes it difficult to put your money to work outside of a "safe" investment (e.g. term deposits), even if that perceived safety means, inflation may destroy your purchasing power over time. It causes people to plan for worst-case scenarios to minimise losses rather than trying to maximize wealth.

Then there is the ultimate cause of going nowhere – **fear of regret**. And right now, fear is by far a more dominant feeling. Frequently, even when a clear course of action is appropriate, people prefer to do nothing or remain indecisive for fear of making the wrong decision.

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Crash of 1987 – a time to sell, or a time to buy?

On October 19, 1987, the now infamous "Black Monday," the US Dow Jones Industrial Average lost 22.6% in one trading session. It was even worse outside of the USA, with markets in the United Kingdom, Hong Kong, and Australia all losing more than 25% by month-end. Yet only two years later, the US market had recovered all of its losses – and gone on to rise dramatically over the next 10 years.

In most cases two years is not a long time from the standpoint of a long-term investment plan. Even someone who is about to retire could still have an investment horizon of more than 25 years. Ultimately, Black Monday represented an excellent buying opportunity for investors who had the courage and commitment to act on that perspective.

Of course, not all of us can be so coolly rational. Counterproductive emotions sometimes determine our decisions, and the market's twin Hydra – fear and greed – can be wickedly difficult to ignore. How can we ensure that our decisions stay consistent with our long-term goals?

How can you avoid counterproductive behaviour?

Determine your risk tolerance.

Are you an aggressive investor? Or more conservative? Can you tolerate wide swings in the market, or are you willing to accept potentially lower returns for lower volatility? Determining your risk tolerance is one of the first steps you should take in setting out your investment plan.

Stay diversified.

The very point of diversification is to limit downside losses in difficult markets. If a market correction happens and you're properly diversified, you'll be less likely to lose a substantial amount – and thus less likely to sell at the bottom.

Think long-term.

Realise that in the history of sharemarkets, very few events have had a meaningful impact on long-term returns. Not the assassination of President Kennedy. Not the fall of the Berlin Wall. Not 9/11. Not the start of the wars in Iraq and Afghanistan. In each of these cases, the US sharemarket (S&P 500) stood higher two years after the event occurred. Broadly speaking, in time companies (and markets themselves) tend to recover from events that may seem overwhelming in the near-term.

Get information.

In difficult times, fear is a natural reaction. One of the best ways to deal with it is to get information. Ask your financial professional questions like, "How do you feel about the economy? How do you think it'll impact the market?"



Should I adjust my portfolio?" The more you learn, the better you'll feel about your ability to make constructive decisions under stress.

Act with courage.

To paraphrase Winston Churchill, courage is the value that makes all others possible. When faced with a difficult market decision, ask yourself, "What would I do if I were going to be brave?" The answer may just be the best move you can make.

So this, of all times, is an excellent opportunity to avoid panicking. Fear is a great motivator – but a bad guide. A better strategy is to stay calm. People who act coolly will make better decisions than those that act emotionally.

What can you do to move past counterproductive behaviours?

1. You may benefit from the help of a financial professional to diagnose biases and correct your course when necessary. Along with determining a prudent strategy for your investments, a professional's role is to protect you from common pitfalls detrimental to your financial security. Their value is demonstrated partly in providing "don't do that" or "it's OK to do that" guidance.
2. Put your money to work with a documented investment strategy. When the plan is established, you may not be as likely to deviate from it – even when markets test our emotions with wild swings.
3. Rather than trying to time your entry points into the market, utilise dollar-cost averaging to contribute to your accounts at regular intervals. Most superannuation investments benefit from this investment strategy as you are drip feeding funds into your superannuation investment on a monthly basis. Although it does not assure a profit or protect against loss in a declining market, it helps maintain a consistent stream of investing in your accounts.
4. Use funds that automatically rebalance. Or schedule at least an annual rebalancing of your funds that forces you to sell some investments that have grown in value and buy some that have been out of favour. Remember, the idea is to buy low and sell high.
5. Resist impulse when markets are racing or retreating. Make sure your decisions are aligned with your long-term objectives.



To help you manage and protect your investments during this volatile period, Russell Investments have put together **Your toolkit for financial security in volatile markets.** It is available on www.russell.com.au and contains some helpful information so that you might gain a better understanding of market cycles – and remind yourself about the benefits of staying focused on your long-term financial goals.