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PITFALLS

OF EMOTIONAL INVESTING

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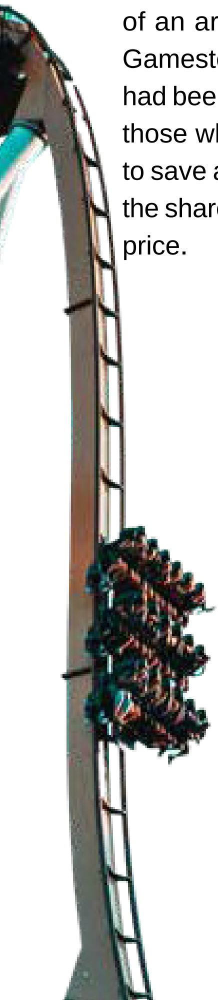
Trust the process more than your gut: The pitfalls of emotional investing

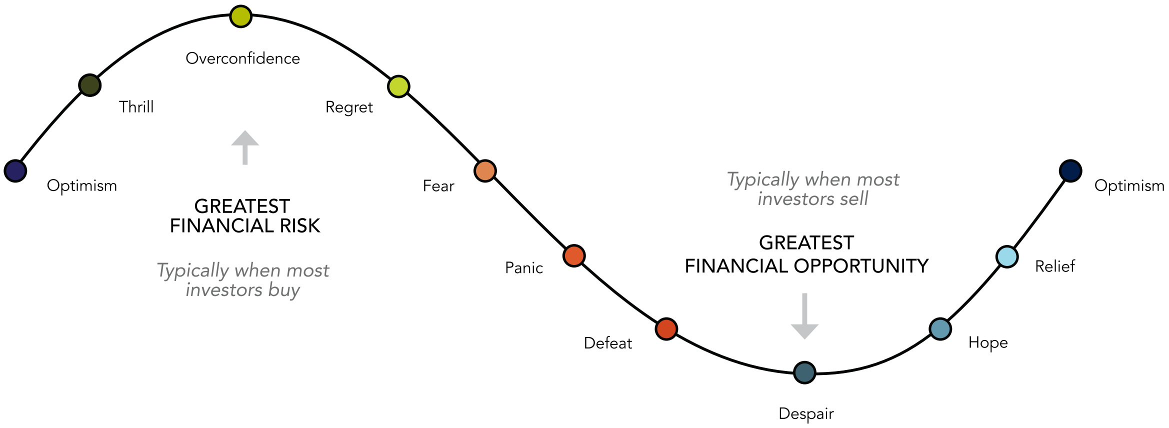
In 2022, one of the oldest brands in the United States of America faced a crisis and was on the verge of bankruptcy. A marquee brand that found its roots in the 70s and 80s was faced with unprecedented challenges building over 2 decades. Bed, Bath and Beyond was the perfect example of the 'American Dream' as two business partners embarked on a journey to create an everyday household name and they were quite successful in the decades that followed. However, in recent years, the company made a number of bad business decisions which led to its fall from grace.

As investors across the board participated in a frenzied selling of the stock, a group of Reddit users decided that they would go the other way. They rallied a number of investors through the social media platform and managed to push up the stock's price temporarily. However, this kind of an artificial price boost had been done before (with Gamestop and AMC) and the rally wasn't as strong as it had been a few years ago. Even then, these investors and those who bought into the narrative that they were trying to save an age-old American brand quickly unraveled and the share price plummeted further below the previous floor price.

Emotional investing is generally motivated by the allure of quick gains and the fear of missing out (usually fueled by pervasive social media noise and instantaneous market updates). This prompts people to act in impulsive ways, based on their emotions rather than a solid analysis. This can distort risk perception, caused by a lack of due diligence and proper risk assessment. Many of the stalwarts of Wall Street have repeatedly warned against the risks of investing like this and promulgate the practice of value investing, yet, investors continue to make instinctual investing decisions rather than rational.

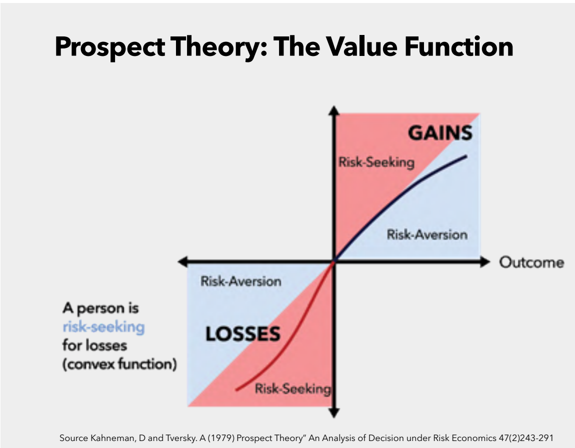
> **Investing shouldn't be an emotional roller coaster.**





Behavioral Finance:
Analyzing the basis of emotional investing

Behavioral finance attempts to decipher different behavioral aspects that have a bearing on an investor's decision making. It is a field that actively investigates and challenges the commonly held notions and assumptions about financial markets and investor behavior. Further, it attempts to address anomalies found in the markets, explaining inefficiencies and market bubbles formed by asset mispricing.



Although the mention of behavioral aspects in finance dates back to the early 1900s, it was formally acknowledged in 1979, in Daniel Kahneman's and Amos Tversky's "Prospect Theory: A Study of Decision Making under Risk". The economist and mathematician brought a unique perspective to the understanding of an investor's risk taking behavior while experiencing gains or losses. The four primary tenets of the theory are: reference points, probability weighting, loss aversion, and diminishing sensitivity. Loss aversion is one of the most salient features of this theory as the theory states that the feelings associated with loss are stronger than the positivity associated with a gain. In the context of the stock market, investors are prone to keep losing stocks, hoping they will rebound, and are more likely to sell gaining stocks, afraid of a potential downturn. The theory presents the potential rationale behind incongruous investor behavior and their emotionally driven probability association to different potential outcomes, based on the kind of losses or gains they have faced in the past.

Based on their findings, the two scholars concluded that rather than calculating the universe of potential outcomes and selecting the optimal one, an emotionally-driven investor calculates outcomes against a subjective reference point, such as the purchase price of a stock. Their work, along with Richard Thaler, laid the foundation for behavioral finance and understanding the biases that can affect the rationality of any investor.

In recent years, this was best exemplified in December 2018, as the S&P 500 recorded the worst December since 1931. A record $89 billion flowed out of equity mutual funds. This panic was triggered by a short term fluctuation in the market. The S&P climbed 7.9% in January, booking its best performance in 30 years. This incident was marked as the perfect example of investors' tendency to enter markets late and leave too early, all of it being driven by an intrinsic emotional bias.

Since Kahneman, Tversky and Thaler established the field of behavioral finance, many instances have given credence to their observations. In a study by DALBAR in 2023, the average emotional equities investor lost 21.17% during 2022, compared to the S&P 500 Index which lost 18.11%. It was worse for the average emotional fixed-income, even though 2022 was one of the worst years for the bond market since 1985.

Inherent Bias: A list worth remembering

Over the years, many biases have been identified that an investor can probably experience. Some of the most pertinent ones are:

1. **Overconfidence Bias:** The overconfidence bias happens when investors rely more on their own belief, knowledge and intellect. This ego-driven tendency gives an investor the confidence that they are better than they actually are. The overconfidence bias tricks the brain into believing it's possible to consistently beat the market by making risky trades.

2. **Loss aversion bias**: Investors with a loss aversion bias have a grave fear of incurring losses. So much so that they stop investing in portfolios which could entail them gain. Here, the pain of loss outweighs the potential gain one can make on an investment. According to Kahneman and Tversky, investors with a loss aversion bias are willing to take on more risk in the face of losses, but become more afraid of risk when it comes to protecting their gains.

3. **Outcome bias**: This is a cognitive and information processing bias, where investors make a decision based upon the outcome and not based upon the process that led to that result. Outcome bias can lead to excessive risk taking.

4. **Endowment bias**: This is an emotional bias where investors value an asset more when they own it, whether due to purchase or inheritance. This bias exists widely with the investors who have attached some emotional feeling towards certain assets or stock. It can be seen as the underweighting of opportunity cost.

5. **Cognitive bias**: Often investors will ignore newly acquired information because it conflicts with previous views due to cognitive dissonance bias. Most people avoid potentially relevant information to avoid psychological conflicts.

6. **Hindsight Bias**: Investors often convince themselves of their prediction capabilities based on an instance when they had predicted the outcome correctly. Based on this, they believe they can predict future outcomes also equally well. Financial bubbles are always subject to significant hindsight bias after they burst.

7. **Herd Mentality**: An investor's tendency to copy what other investors are doing is what is referred to as herd mentality bias. With such a bias, an investor does not rely on one's own analysis. Rather, they find it more appropriate to follow the analysis and investment plan of other investors.

8. **Trend Chasing**: A trend chasing bias is one where the investor follows the trend and news to buy a stock. Some investors will look at trends of just the recent past and make it part of their long term investment plans. Most investors with the trend chasing bias purchase stocks based primarily on price movement.

The problem with emotional decisions in investments

The biggest concern for the old guard of Wall Street is what motivates the trading decisions of most investors in the stock market. The rise of social media and new technology has fostered a fast moving environment of data, information and news. Short term gains are given higher emphasis by retail investors. Investing based on trending topics is not uncommon. This coupled with a free access platform like Robinhood creates a suitable setting for instinctual or emotional investing.

Let us consider the story of GameStop. Based on the comments of a user on a social media platform, users converged to increase the video game distribution company's stock by purchasing it in bulk. Presented as a planned revenge on a hedge fund that is a majority shareholder in GameStop, the heavy buying decisions led to an increase of 1700% (at its peak) in the stock price of the company.

While the investors saw this as a victory over a multi-billion dollar hedge fund, most investors didn't know that GameStop in 2021 had no online operations. Fewer still would have studied their business model and recognized that the company was still invested in operational methods that are slowly becoming obsolete and its customer retention strategy was primarily an outdated reward program. It is only after this surge in prices that the company has considered creating an online store front. For that to happen though, they will sell 3.5 million additional shares to raise 1 billion dollars more. For the uninitiated, emotional investor, this means a further dilution of their holdings. The surge in the stock price has definitely raised its price band but the price has begun to stagnate, similar to how it was before January. Those who bought the stock at the peak of the surge may not be able to recover their investment for a very long time.

Emotional investing and decision making makes people easy targets for questionable (even fraudulent) investments. Whether it's GameStop's artificial surge, elaborate Ponzi schemes (read Bernie Madoff) or the increasingly frequent 'pump and dump' scams (especially in the cryptocurrency exchanges), they gather most attention from investors who trust their emotions over the facts while making investment decisions. The promises range from 'sticking to the man' to 'owning a currency of the future' and each of them appeals to a different emotional bias of an investor.

With a sustained emphasis on short term gains, the basic instincts of an untrained investor are awoken when they strongly want to believe they can get ahead, with a strategy based on their gut, not a proven process.

Practices to maintain a healthy portfolio and avoid emotional trading

The only real way to have long term success as an investor is to choose a process that suits one's personality and goals, and have the discipline to stick to the process. While that might be easier said than done, here are a few thoughts to keep in mind while designing a process worthy of one's personality:

1. **Returns are important, but they are not everything**: The topsy-turvy nature of the stock market can be quite unsettling when a seemingly tectonic shift happens. But what would be even worse is reacting to it by buying or selling stocks in a panic. Any investment plan or stock must work long term and that makes the company's credentials equally important as the returns. Choose whether to invest or not based on how well the company is geared to weather such infrequent fluctuations.

2. **Practicality and realism should guide you**: While creating an investment plan, dwell and practically address individual strengths and weaknesses. Depending on that analysis, design a portfolio that suits the identified risk taking appetite. At the beginning of his career, famed investor Warren Buffet focused only investing in companies that were undervalued but had it in them for one final push before diversifying or shutting shop. It was a queer strategy but one that suited his personality very well. A diverse and longterm plan that has been created with envisioned goals in mind shall help set realistic and practical expectations in the future.

3. **Avoid the emotional triggers**: Whether it is joy, fear, ambition or anguish, they are all emotional triggers that cloud an investor's judgment. As human beings, it is natural to experience them from time to time. What should be avoided at all costs is the influence it has on investment. decisions. Whenever the inkling of an emotional influence is felt, find a way to express it somewhere else. It certainly isn't wise to make investments and then let complacency set in, expecting that the same investment will get you the best returns every year.

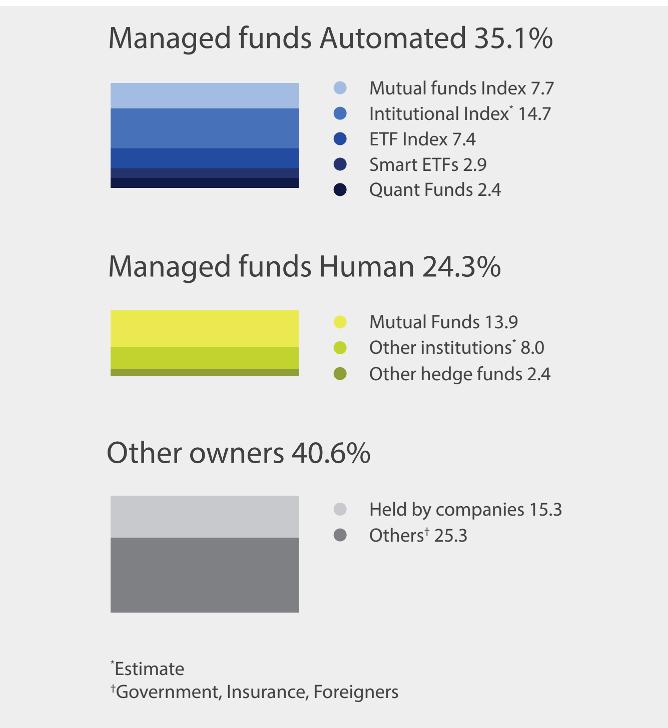
4. **Think long term**: Emotional investing usually takes over when long-term plans do not exist. Then, it's equivalent to flying without wings with no definite destination. Veering off track and suffering irreversible consequences might be the only certain outcome without a long term plan. Investments need time and direction to grow. Short term plans may gather momentary gains, but it triggers an addictive mindset which can be very difficult to escape. Long term goals allow room for modification, improvement and intelligent planning.

5. **Take Professional Help**: Always consult professional financial advisors as it could be a worthwhile investment. The fees paid and his advice received will be beneficial in the long run. However, choose advisors carefully by considering his experience, knowledge and reliability.

Process over profit: The best guiding philosophy

The evidence of the overpowering strength of non-emotional trading is stacking up steadily. A 2018 study published in the Journal of Financial Planning found that investors who use a behavior-modified approach to investing which removed emotion from saw returns up to 23% higher over 10 years. With the path breaking developments in artificial intelligence, Exchange Traded Funds (ETFs) and index funds, which are managed and rebalanced by goal-driven algorithms, have overtaken human managed asset managers in US equities. As per The Economist, since 2019, the US stock market has been witnessing a slow takeover by these computers and algorithms. The division of the $31 trillion US equities market has seen quant funds (ETFs and index funds) own 35.1% of the market capitalization, while human-managed funds own 24.3%.

In light of these findings, for a human investor, the virtue of following a process and staying dedicated to it is not easy, but it is nonnegotiable at this point. In fact, during a market fluctuation (like the one induced by COVID-19 in 2020), it is almost impossible not to have an emotional reaction to the investing process. Panic and anxiety regarding investments can set in. This is where having professional assistance can be very handy to navigate your own emotion-driven doubts. With a professional hand explaining the best possible move as per the chosen strategy, it is possible to mitigate the emotional triggers that become overpowering in such a situation.



If the goal is to make gains over the long term and have a diversified portfolio of holdings, always trust the process. Profit always follows the process.

The meme stock story of Bed Bath and Beyond is a prime example of how social media and online communities can have a powerful impact on stock prices, often leading to significant fluctuations that deviate from traditional financial analysis. It is a reminder of the changing landscape of investing and the influence of collective sentiment in today's interconnected world.

If one is able to leave emotion out of the equation and stay true to a chosen process, one would most likely wait and see whether the value associated with a certain stock or investment lives up to its billing. At some point, a long-term investment opportunity will present itself. If one is unable to leave emotion out and abandons the chosen process, then it is possible to get swept away like the many investors in the GameStop, AMC and Bed, Bath and Beyond debacle who may never recover their investment again.

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Disclosure: