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Emotional Investing

Successfully investing in the stock market can be very challenging. To do it as a formal profession typically involves years of post-secondary training and often another designation or two beyond that. Outside perceptions of this training typically consists of valuation ratios, cash flow statements, and the like. The emotional and psychological discipline required to stay calm and make rational decisions in turbulent environments is often overlooked. Left unchecked, our emotions can negatively influence our behaviour.

Level three of the Chartered Financial Analyst (CFA) designation focuses, in part, on investors' behavioural biases. Most members of QV's Investment Committee have their CFA designation and others have studied that portion of the curriculum. Despite our familiarity with behavioural biases, they still rear their heads at QV on occasion. Scott Barlow from The Globe and Mail recently wrote an article about these biases, which Joe Jugovic brought to our Investment Committee meeting as a reminder for us to remain aware of them while investing.

The five biases that Barlow references are loss aversion/anchoring, herding, confirmation bias, recency bias and outcome bias. We feel the temptation of each at certain times.

Loss aversion/anchoring refers to the fact that humans feel more pain from losses than pleasure from gains. It is for this reason that some investors feel they need to hold onto a losing stock until they can recoup their money spent, even if they suspect further losses are ahead. Occasionally we need reminding that, excluding tax concerns, the purchase price of a stock is irrelevant to future trading decisions.

Herding refers to the urge to invest based on consensus. Often, investors are afraid of missing a stock market rally that has already begun. In reality, if one invests at this point there is a good chance they have already missed their opportunity and are buying stocks that have become expensive with little downside protection. As value investors, we tend to be somewhat contrarian so it can be unsettling at times to watch a rally unfold in momentum stocks while holding value companies. Although sticking to our guns has its challenges, we remind each other that it is profitable in the long run and it is why our clients entrust us with their funds.

Confirmation bias refers to the tendency to discount the importance of new information that is contradictory to one's thesis on a current investment. Credible arguments can usually be made to support or refute almost any investment decision. It is far more comforting to read research that confirms one's decision and investment prowess than it is to objectively weigh evidence that pokes holes in one's thesis and intelligence for making such a decision. Fortunately, objective thinking is what we are paid to do so we find time to thoroughly research both sides of the story.

Recency bias refers to the assumption that something that has happened in the recent past will repeat itself in the near future. We have struggled with this in the wake of the financial crisis of 2008. It is difficult to find investments with expected returns that warrant their risk when modelling a repeat of one of the worst financial meltdowns in history. We usually err on the side of caution, but in this situation we would hold a 100% cash allocation if we did not look beyond that crisis.

Outcome bias is my favourite. I believe it is responsible for much of the arrogance in this industry. It refers to the satisfaction of getting an investment right, even if it was for the wrong reasons. Barlow highlights that stock prices can only go one of two ways, so we have a 50% shot at getting any given investment's directional price movement correct. It is refreshing to hear an investor say "we got lucky on that one", but sometimes that is all it is! Ahem… even here at QV. Investment performance is best measured over the long term where the consistency of sound decision making presents itself.

Successful investing would be a much easier task if we were heartless robots, but alas, investing is wrought with emotions that we are susceptible to. Dealing with them appropriately is something that requires focused effort and attention.