THE PSYCHOLOGY OF INVESTING

Audio Script

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Audio Script:

Hi everyone, thank you for tuning into this session on the psychology of investing. When it comes to investing, most of us immediately think about the different investments we can pick. We'll ask ourselves: "which stock will make me the most money this year? What can I invest in that will reduce my taxes?". Essentially, what we want to know is: "what portfolio do I need to create to reach my goals?". But investment success doesn't begin with our portfolio. Even the ideal, hypothetically perfect investment strategy will fail if its owners keep making changes to it. Investor behavior in times of volatility like what we saw in 2020 was especially impactful to the bottom line, whether it was the fear in March and April at the beginning of the COVID crisis, or the hesitation to get back into the market when it rallied and recovered.

The main message today is this: the way you behave as an investor can often have a big impact on your financial outcomes. Today, we're going to walk through some of the common mistakes that investors can make when they mix their emotions with their decision making, and then how to prevent them.

If you had to put your money in one investment today, which would you choose? The green line? The yellow? Blue? Or the pink one? Studies have shown that investors are most likely to pick the yellow graph. As human beings, we are wired to be drawn to reward, and fearful of risk. We like this steady and sure growth of our money. If we had a choice, we would choose this investment every time. Now, let's reveal what these investments were.

Green represents Pfizer stock, blue is the S&P 500 index, pink represents U.S. Treasury bills, and yellow represents Fairfield Sentry. Has anyone ever heard of Fairfield Sentry? How about Bernie Madoff? Fairfield Sentry was the feeder fund to Bernie Madoff's "investment firm". The one investment that went up with seemingly no risk turned out to be one of the biggest frauds in US history. And history has shown that there are no magic bullets. Investing involves risk. And as human beings, it can be tough to manage our emotions when markets go up or go down. In this video, we'll show you how to recognize your emotions, explain why those emotions can affect your money, and how to work with your financial professional or develop disciplines to put into practice to best position yourself to meet your financial goals.

Investing isn't about being smart. Here's a story that illustrates what I mean. Isaac Newton is considered one of the most important scientists in history. Even Albert Einstein said that Isaac Newton was one of the smartest persons that ever lived. Newton developed the theory of gravity, the laws of motion (which forms the basis for physics), new math, calculus, and made breakthroughs in developing the modern telescope. In 1720, far before Bernie Madoff, and far before bitcoin, Sir Isaac Newton lost £20,000 (well that's more than $3 million in today's money) by investing in the South Sea Company. There's more to that story though. He had actually earned £7,000 (or close to a million dollars in today's dollars) from the same stock a few months earlier. But he bought back in after the stock skyrocketed thinking he was missing out, eventually leading to his tremendous losses. Newton concluded this...he 'could calculate the motions of the heavenly bodies, but not the madness of people.'

When it comes to investing, it's important to try our best to separate our emotions from our decision making, as hard as that may be. When external factors are around us and they're rough, it can enhance the fear of loss that we naturally have with our investments that we internally have to reconcile. All of the media that we're constantly bombarded with now doesn't really help and is typically even the cause of that feeling. The big takeaway, as Warren Buffet said: "We don't have to be smarter than the rest. We have to be more disciplined than the rest."

So let's talk about the psychology of investing, and how to build in that discipline. By understanding the psychological factors of behavioral finance, we can better understand why investors often make buy and sell decisions that contradict investment best practices and rational investing. More importantly, by understanding common investment behaviors that lead us astray, we can learn how to recognize and avoid these tendencies. 'Envy' (or the fear of missing out or the regret of what could have been) and 'loss' (so, losing money, where losses feel twice as bad as gains feel good) are common investing challenges that prevent average investors from becoming ideal investors. This video will illustrate these common behavioral

biases and show you how to implement disciplined strategies to inspire a smoother, more disciplined approach to investing. First, let's start with envy.

Envy

Envy is that emotion that gets us thinking "what if?". Also known as FOMO, or the fear of missing out. The fact that most people regret what could have been can be very damaging if that starts to take over their emotions, affecting their thoughts about their investment plan.

Rational people would regret only bad final outcomes, but most people regret what could have been. For example, a study looked at Olympic medal winners and found that bronze medal winners were happier than silver medal winners. Why? A silver medalist likely thinks about how close they were to achieving gold. A bronze medalist, though, might imagine how close she was to not receiving any medal at all. Depending on the alternative, a person feels either relief or regret. While relief is a positive emotion, regret can be a painful and bitter experience. While you might not stand on a podium anytime soon, the reactions of medal winners gives us insight into a universal truth: happiness is relative. In an ideal world, we need to imagine that regret we would feel if we had an emergency but didn't have the savings to cover it. But that can be hard to do.

For investors with a diversified portfolio, we saw a lot of regret coming into the start of the year with investors when they looked at their portfolios vs. US stocks. We call this S&P Envy. And it's easy to see how this S&P Envy comes about- and its more than just the last 11 years. It's the inability for investors to connect the dots of investment returns over various market cycles. In a bear market, a diversified portfolio still loses money- that never feels good. Then in the bull market rebound you might trail the index. For example, in 2008 you lost more than 20%, one of the worst years ever for a diversified portfolio. And then in the 9 years from 2009 to 2019, the diversified portfolio trailed US stocks by 160%. Bringing back to this historic first quarter of 2020, you then found yourself losing money yet again in a very sudden, very severe market drawdown, and this was followed by a huge comeback for the remainder of the year. You can see where this S&P Envy comes from – the diversified portfolio never feels like it's quite winning. You lose money, you trail the market, you lose money, you trail the market. A diversified portfolio is difficult to own – it never feels like you are ahead, often leading to a feeling of regret. We start to wonder to ourselves, "Why am I losing money? I thought my portfolio was diversified?" or "Why does my portfolio always underperform? I think I'm leaving too much money on the table." But the punchline is that if you add up all of these periods, the diversified portfolio actually works even when it feels like it's losing. This kind of regret and not understanding why we build portfolios the way we do, can lead to bad investment decisions.

Another example of envy: most people will tell you that buying a lottery ticket is a poor plan for financial success. But why are we willing to play even when we know the odds aren't in our favor? We are often willing to accept this high probability of poor returns for a small chance of earning large returns. This is called the "lottery effect." This is also why investors are willing to concentrate positions in single issue stocks or invest in the next "hot" startup company or the latest investment trend. The excitement of large returns clouds our better judgment and we make decisions that reduce our overall chance of success.

We run into serious risks when we get caught up in the "lottery ticket" effect. If you've succumbed to S&P Envy and started "stock picking" individual stocks, there was a roughly a 1 in 3 chance that you picked a stock that would have lost money from 2016 to 2020. Whereas if you invested in a basket of securities like a mutual fund or an ETF, only 0.2% of those funds lost money over that same 5-year period.

And as it turns out, limiting losses (especially big losses) is the true key to investing success. Warren Buffet has said that the first rule of investing is not to lose money, and that the second rule of investing is to not forget the first rule. It's all about the math. If you start with $1 and lose half (so 50%) you are left with $0.50; what do you have to earn to be up to breakeven?

You need to double that or be up 100% to get back to par. But what if you were only down 10%? Some might think you would need 20%. But really, a loss of 10% requires an 11% gain to recover- that's quite manageable. But it goes to show that it's not a linear progression like we think. In fact, as the losses grow

larger, the size of the return needed to recover increases at an even faster pace. Look back at the 50% loss (where you needed a 100% gain to recover) an additional 10% loss from there (so from 50% to 60%) requires a 150% gain just to get back to even. And an additional 50% needed to get back to breakeven from a 50% loss to 60% loss. With individual securities, it's very possible to see a large drop in value, but it's much less likely in a diversified portfolio. When you give into envy, the results can make you lose sight of this important fact.

Loss

If you're not suffering from envy, good job: you're probably constantly trying to minimize your losses. But on the other side of the spectrum, people will do irrational things to avoid losing things. This is where we run into loss. The overwhelming fear of losing your money can be just as harmful as not fearing it enough. Sometimes, it can feel even worse. In fact, studies have shown that the pain of losing is twice as strong as the joy of winning. When things are already looking rough, it can enhance the fear of loss that we naturally already have with our investments. If we give into it, we may start to wonder what's the worst-case scenario and what that may look like.

All of us have a natural tendency to take action and try and fix our problems, to take control, rather than doing nothing. But taking action in these times isn't always necessarily the best solution. To draw an analogy here: Imagine yourself as a goalkeeper in soccer. Studies have shown that statistically, you are more likely to stop a penalty kick by staying in the middle. That's not to say you should always stand in the middle, but we are often emotionally geared to fix or do something when we are feeling anxious. This is what behaviorists call "action bias," or thinking that value can only be realized through action, or to the tendency to act as opposed to practicing restraint. This was especially critical at market lows in 2020. Investors who were focused on their goals and less about what the market was doing likely did better than those who acted out of fear.

Taking action or "trying to fix" your investment portfolio often leads investors to trying to time the market. Missing just the 5 best days over the last 20 years could have cost your portfolio more than $100,000– nearly a third of its potential value. And if you were unfortunate enough to miss the 25 best days, you'd have less money than you started with. A reality to consider is that 24 out of the 25 best days came in the market within one month of one of the 25 worst days in the market. So overreact to any one bad day, and you could miss out. So the story here is this: don't let your fear of loss drive your investment decisions. Since we can't predict when the best days will be, staying invested is often the best strategy. It's all about time in the market, not about timing the market.

On the other side of this, when people get fearful with their investments, they tend to pull out of markets completely, fleeing to cash. These "sideline sitters" might say: "I don't want to make any changes right now, my stocks have done well", or something like this, "With the markets hitting new time highs, I have missed it and I'll wait for a better time." But there is no "best time" to invest (really unless you're a fortune teller). Instead, it's important to get invested sooner rather than later in order to take advantage of the power of compounding gains. In this hypothetical example where your money grows 10% each year, the difference between investing for 10 years versus 5 years isn't just 100% more – it would be 261% more - almost three times as much. Albert Einstein once said that compound interest is "the eighth wonder of the world.... he who understands it, earns it; he who doesn't, pays it."

It may seem counterintuitive, but it can be helpful sometimes to take a contrarian approach. As Warren Buffett famously put it, "be fearful when others are greedy. Be greedy when others are fearful." This was especially true before and after the financial crisis in 2008. Investors ultimately lost as they rode the highs of the market in 2007, and perhaps they pulled out of markets during the depths of the crisis where there was so much uncertainty – they then missed out on what tuned out to be a historic bull market.

Building Discipline

So, it's easy to lose ourselves in our emotions. If we go one way and get too aggressive and we take a lot of risk, we can really harm ourselves. At the same time, it's just as easy and just as harmful to be too conservative. That just leaves a very narrow, disciplined middle-ground for us to navigate. So let's explore why it's so important to be disciplined, and what we can do to get there.

It starts with making a plan. Yogi Berra once said, "if you don't know where you're going, you'll end up somewhere else". So, making a plan in advance and sticking to it give you a blueprint to respond to a situation that helps remove emotion. Another avenue, and this might work for some, is consulting with a financial professional. Experts have suggested that when you're trying to break a bad habit, it's really helpful to tell someone else so that they hold you accountable. They can keep you disciplined and on-schedule when you may feel like deviating. When it comes to investing, for some, the perfect person for that job is a financial advisor. Many people think of financial advisors as "money managers": people who can make your money work as well as possible. And that's true. But just as importantly, they act as an intermediary, a stop gap, between you and your investments. In reality, a financial advisor's primary job is not to worry about your portfolio, but to guide you through the wealth-building process by helping you avoid common mistakes.

Whether you're doing it yourself, or you're working with an advisor, sticking to a disciplined plan can help to make the emotional rollercoaster ride of the markets smoother and less volatile. That's the power of preparation at work. Creating an Investment Strategy Plan, a plan that will help dictate your investment strategy, regardless of the noise of the day and regardless of external forces, this can help as an anchor. That way, when your emotions start to influence you, there are guidelines that can be followed to stop any impulsive actions. Ben Graham, considered the father of value investing, and mentor to Warren Buffett, said, "For indeed, the investor's chief problem, and even his worst enemy, is likely to be himself".

As we mentioned, no one can predict what will happen next in the markets, not even expert analysts on Wall Street or on TV. In a survey, only 43% correctly predicted whether interest rates would go up or down, less than the chance of getting heads from a flip of a coin. We can't control the future, only ourselves and how prepared we are to face it. So let's turn off the TV, or at least don't overweigh what news sources are telling you. And I'll quote Yogi Berra again, where he once said, "It's tough to make predictions, especially about the future."

So to recap: Recognize these common mistakes and the tendency to repeat them. Be willing to be critical, even when times are good and opportunistic when times are bad. Invest for the long term – don't try to time the market. Create an investment strategy plan that outlines how much loss you are willing to take and with what conditions should be met in order to make buy and sell decisions, or work with a financial advisor to keep you in check and ensure you are acting and reacting as rationally as possible. In the end, how we behave has a huge impact on how our portfolios behave, and often times the more we try to step in the worse we can make it. So work recognize and mitigate the impact your emotions have on your investments.

When I was a kid, there was always these commercials with the tagline, "the more you know". Well, the more you know about behavioral biases, the better the outcome for financial success.

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