EMOTIONS AND INVESTING

Don't let your feelings cloud your investment decisions.

Our emotions are part of our everyday lives. When it comes to finances, however, getting emotional tends to disrupt even the best planned investment strategies. Case in point: Emotions, and the behaviors they trigger, were part of the reason why individual investors underperformed the S&P 500 by nearly four percentage points, on average, over the past 20 years.[1] That's because the desire to jump into a hot investment and to sell losers in order to avoid further losses tends to generate a pattern of buying high and selling low, according to behavioral economist Richard Thaler, who teaches at the University of Chicago Booth School of Business. That mistake is what behavioral economists call overreaction. "And it's not a particularly good strategy," Thaler says.

Emotional investing can lead investors to make irrational decisions that result in buying high and selling low.

Missing out on returns can make it harder to meet your goals of saving for retirement, or setting aside money for your child(ren)'s education. Fortunately, being aware of your emotions and the common ways they can undermine your decisions about money can help limit the negative impacts on your long-term financial plans.

COMMON EMOTIONAL INFLUENCES

The following behavioral finance concepts reflect how emotions can have very real impacts on our ability to make the right financial decisions.

Short-term thinking. Humans tend to discount future rewards compared to more immediate benefits. As a result, it is often hard to make long-term goals a priority in our everyday decisions. We can understand the importance of saving for retirement or a child's college education, yet still find it hard not to splurge on a new car or relaxing vacation.

Loss aversion. Short-term thinking becomes especially problematic when you consider another piece of behavioral finance wisdom: People tend to fear losses more than they value gains. This phenomenon, known as loss aversion, can lead investors to engage in risk-averse behavior that actually puts their investments in greater jeopardy. For example, our rational minds understand the markets will bounce back from a downswing, but our emotions lead us to overreact. "We think we will be smart enough to take the long view, but when markets actually drop we lose our courage and sell at the bottom," says Thaler.

Investors tend to overrate their own abilities and react too strongly to market events.

Overconfidence. Studies have shown that the majority of investors consider themselves "above-average," even though we can't all be above-average. One study found that investors over-estimated their performance by as much as 11.5% per year.[2] "People believe they are better than everyone else, in spite of the evidence that most people fail to beat the market," Thaler notes. Studies also show that more confident investors tend to conduct more trades,[3] even though, as Thaler notes, "Lots of trading tends to kill performance."

[1]Dalbar 2013 Quantitative Analysis of Investor Behavior. (http://qaib.com/public/downloadfile.aspx?filePath=freelook&fileName=advisoreditionfreelook.pdf)

[2]Glaser & Weber. 2007. Why Inexperienced Investors Do Not Learn. *Finance Research Letters*. (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1002092)

[3]Trinugroho & Sembel. 2011. Overconfident and Excessive Trading Behavior: An Experimental Study. *International Journal of Business and Management*. (www.ccsenet.org/journal/index.php/ijbm/article/view/8801)

KEEPING EMOTIONS IN CHECK

Human behavior will always be influenced by our emotions; that's just how we're wired. But even if we can't override our emotions, we can learn to manage them — and limit the extent to which they influence our financial decisions. One way to avoid the impact of emotions on the decision-making process is to set up rules ahead of time that will direct your investment decisions. For example, you might set up a plan to sell a portion of your company stock holdings once they reach a certain threshold or percentage of your portfolio. This type of strategy can help remove emotion from your decisions on when to sell, and it can help avoid holding concentrated positions in your portfolio.

Keeping a focus on long-term goals can help reduce emotions' negative impact on investing.

Working with a financial advisor can also help you limit the influence of your emotions on your financial decisions. For instance, an advisor can help you better gauge the level of risk you can tolerate while also helping you understand how much risk is needed to help you reach your long-term goal. By developing a long-term investment and asset allocation strategy you can help maximize your financial flexibility while giving yourself a plan you can focus on regardless of the current circumstances. With a focus on your goals and a solid, long-term plan in place, you'll have something to reference that will help you avoid overreacting when the stock market undergoes a correction.

When you do have an emotional response to market news, acknowledge that response and understand that it's perfectly natural. But you get to decide whether you let that emotion dictate your actions. Remind yourself that you have a long-term plan and that momentary blips in the markets were factored into that plan. Better yet, unplug from the market news altogether. The smartest approach is not to think about it too much," Thaler says. "Your focus should be on the long term."

If you're worried about how your emotions are influencing your decision-making process, contact Commerce Trust to be put in touch with an advisor who can talk further with you.

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