

Investor Behaviour

Don't get sidetracked by your emotions or short-term fluctuations

By Clay Gillespie

In the 2011 Quantitative Analysis of Investor Behaviour study by Dalbar, Inc. (a U.S. research firm), it is suggested that investment return is far more dependent on investor behaviour than on fund performance. Mutual fund investors who simply remained invested earned higher real returns than those who attempted to time the market. Between 1991 and 2011, the average investor earned 3.83 per cent per year. But the S&P 500 earned 9.14 per cent per year.

The Dalbar study also reported that the average hold period for the average equity fund investor was only 3.27 years and concludes that: ***“One of the most startling and ongoing facts is that at no point in time have average investors remained invested for sufficiently long enough periods to derive the benefits of a long-term investment strategy.”***

Given that the average investor seeks the best-performing investments to suit their situation, shouldn't the average investor achieve at least the average investment return? The answer is quite simple — it all comes down to investor behaviour; investors do not always make the most rational decisions.

Investor behaviour is characterized by overexcitement and overreaction in both rising and falling markets. The average investor has the tendency to purchase or increase their holdings in investments that perform the best in the short term. At the same time, these same investors tend to sell or reduce their holdings in investments that have performed poorly, again, in the short term.

As a result, just prior to a market correction, the average investor will hold a portfolio that is heavily weighted in asset classes that have demonstrated the best short-term performance. Since a large proportion of monies has been added to these investments after most of the growth has occurred, this strategy leads to a dramatic decline in his/her portfolio when the market corrects. During a stock market correction, investors tend to panic, believing that they will lose all or most of their money, and so the most common reaction is to sell to "cut their losses."

This behaviour drags the market down further than fundamentals suggest — it is a self-fulfilling prophecy. Ultimately, this leads to a deeply negative sentiment about investing in general. But by definition, in every portfolio, one investment holding will be at the "bottom" of the heap. Investors need to analyze their portfolio as a whole, rather than spending too much time worrying about individual investments.

To further complicate matters, the market does not, and will not, react in a predictable manner over the short term. The important point to keep in mind is that these short-term stock market trends have nothing to do with the underlying investment climate.

When adjusting your portfolio, you always want to make changes from a position of strength. The best time to make changes to your portfolio is during a rising market. This does not mean selling the investments you think are "dogs" (although, sometimes, you need to do this) and buying investments that have recently done well. This means selling a portion of the investments that have been profitable — you want to realize some of your profit.

Spending the time to understand your risk tolerance is one of the most crucial steps to successful long-term investing. If you invest in a portfolio that is too aggressive for your liking, then during the inevitable stock market correction, you will be tempted to make changes to your portfolio, thereby guaranteeing yourself a loss.

You should endeavour to develop a long-term investment strategy that takes into account, not only your risk tolerance, but also your goals and objectives. In summary, allowing your emotions to guide your investment decisions is a no-win situation. Focusing on short-term market fluctuations will likely achieve nothing more than a much lower rate of return than if you had done nothing at all. Instead, look to your personal plan to guide your investment decisions.

Clay Gillespie is a portfolio manager and managing director at Rogers Group Financial. The views expressed are those of the author and not necessarily those of Rogers Group Financial, which makes no representations as to their completeness or accuracy.

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