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Focus Article

Emotional investing: Getting past our biases

Investors should avoid the pitfalls of getting swept up with the herd in the "next big thing" or compartmentalizing assets into distinct mental pools.

Andrew Maxwell & Alan Weider

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RBC Wealth Management

Emotional investing: Getting past our biases

Andrew Maxwell
Jersey, British Isles
andrew.maxwell@rbc.com

Alan Weider
London, United Kingdom
alan.weider@rbc.com

When it comes to making complex decisions, many people follow a series of simple rules of thumb that are very often based on deeply ingrained biases. This can lead to irrational decision-making. While these biases might be useful in helping individuals cope with day-to-day choices, they can be unhelpful when it comes to long-term activities such as investing. Individuals can be coached to understand their own biases helping them to make better investment decisions.

We began this series in October 2017 looking at loss aversion and narrow framing. In this issue, we focus on two of the most common and, we think, most timely investor biases—the so-called "herding mentality" and "mental accounting."

The herding mentality: Be wary of getting carried away with the "next big thing"

In 2005, an unusual and unfortunate event took place in Turkey. Shepherds were left bewildered when a sheep decided that it had enough of this world and jumped off a cliff to its death. Sadly, a further 1,500 sheep were reported to have followed the first over the edge. While some did not survive the drop, a number were saved thanks to the cushioned landing that had been created.

Whether the above story is fact or myth, this type of behavior, known as herding, does exist—and it is not exclusive to livestock.

Investors who feel the need to participate in the "big thing" of the moment are often so carried away by emotion that they invest without due care or consideration. It has been said that "Take my money!" could be heard on the floor of the New York Stock Exchange during technology IPOs at the height of the 2000 bull market, right before the tech bubble burst.

Human nature

A few reasons have been put forward to explain why investors might be caught up by this phenomenon. For example, some people may choose to follow the herd in the belief that the masses are better informed than the individual.

Alternatively, people can take comfort from being in a crowd and with fitting in. Aversion to extremes is a common human trait. So is fear of being left out—many investors plunge into speculative, unknown waters because they don't want to experience the feeling of regret that would come with knowing they had missed a big success that everyone else participated in.

Changing tack

Instead of jumping into certain stocks simply because they are "in fashion" or on unsolicited advice from a friend or colleague, it is always worth first considering the Warren Buffett mantra: "Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."

Investment decisions need to be taken rationally and only after taking time to reflect and, ideally, consulting a financial adviser. Consider a portfolio where the investor chooses to give decision-making discretion to a professional manager. Typically the investor would employ multiple fund managers, preferably achieving a blend of different approaches and investment styles rather than leaving the portfolio focused solely on what's in fashion.

The soundest advice is to always do your homework before following any trend.

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Consider outsourcing the background work to an investment firm that is sufficiently large and well-resourced to carry out the due diligence necessary to enable rational decision-making.

Mental accounting: Thinking of assets as separate accounts rather than one portfolio can cause investor errors

Investors have a habit of splitting their assets into a series of different pots, each with its own use, rather than looking at their wealth as a whole. This is called mental accounting.

For example, cash that has been assigned for one purpose, say a holiday, is generally not thought of as being available for a different goal, say buying a new car.

A loss is always a loss

To give you a better picture of mental accounting in practice, imagine that you are eager to see the next blockbuster film in the cinema.

- You have already paid the admission cost of £10, but as you enter the cinema you notice that you have lost the ticket and the theatre will not admit you without proof of purchase. Would you pay another £10 for a new ticket?
- You take cash with you to the cinema to pay for the ticket, but as you go to purchase your ticket you notice that you have lost a £10 note on the way. Would you still buy a ticket?

Although the financial loss is the same in both cases, experiments with large numbers of people show that a person is less likely to spend another £10 for a ticket in the first scenario, but will use another £10 note to buy a ticket in the second. In their minds, the £10 in the first case had been assigned to the "film" account and had been spent. But in the second, the lost £10 had come from a "different pot."

Mental gymnastics

People can suffer similar biases in an investment setting.

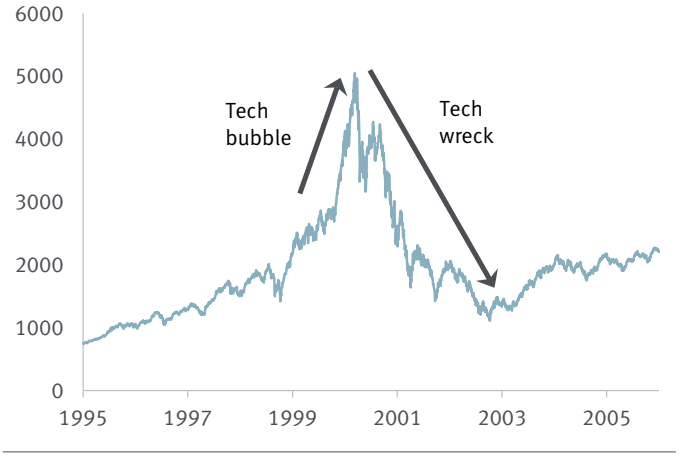
Taxes are one of the few inescapable aspects of life, and most governments tax capital gains earned on investments. As with most taxes, investors have a tendency to make a host of errors in attempting to avoid creating a tax liability.

For example, they may not sell out of a fund that is sitting on a large gain, even though better investment opportunities are available elsewhere, because they would be liable for tax on those gains. This type of behaviour is due to investors putting their tax liabilities into a separate mental account than the investments it came from.

The very high cost of such thinking was a prominent feature of the tech bubble of 1998–2000 and its aftermath the "tech wreck" of 2000–2003. When tech shares were flying high, many investors could not bring themselves to sell because the thought of writing a large cheque to the government at tax time was so painful. When the tide turned, the thought that an investor's tax liability was falling must have been cold comfort as most shares plunged to a fraction of their peak values.

Painful lesson learned

NASDAQ Index (1995–2005)



Source - RBC Wealth Management, Bloomberg

Putting tax (the cart) before potential future returns (the horse) can lead to bad investment decisions.

Taking stock

Investors should be pleased to have built a capital gain; it means their wealth has grown. But if that new wealth is never realised by selling the asset, then that additional wealth never really existed.

One way to avoid those biases is to mentally apply a capital gains tax cost directly to an investment.

One way to avoid those biases is to mentally apply a capital gains tax cost directly to an investment. If, for example, a holding is up by 10%, do not think of it as really up by 10% but instead remove whatever the capital gains tax would be—say 20% of the gain—so that the investment is really only up 8%. When the asset is then sold, in your mental accounting, 20% of the gain has already been notionally set aside to pay the tax liability.

Investors will no longer need to cover the tax loss from a different mental account and it can be attributed to and covered directly from its source.

Research resources

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Jim Allworth – Co-chair; Investment Strategist, RBC Dominion Securities Inc.

Kelly Bogdanova – Co-chair; Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Capital Markets, LLC

Frédérique Carrier – Co-chair; Managing Director, Head of Investment Strategies, Royal Bank of Canada Investment Management (U.K.) Limited

Mark Bayko, CFA – Head, Portfolio Management, RBC Dominion Securities Inc.

Craig Bishop – Lead Strategist, U.S. Fixed Income Strategies Group, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

Laura Cooper – Head of FX Solutions and Strategy, Royal Bank of Canada Investment Management (U.K.) Limited

Janet Engels – Head of Portfolio Advisory Group U.S., RBC Wealth Management, RBC Capital Markets, LLC

Tom Garretson, CFA – Fixed Income Portfolio Strategist, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

Christopher Girdler, CFA – Fixed Income Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group, RBC Dominion Securities Inc.

Patrick McAllister, CFA – Canadian Equities Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Dominion Securities Inc.

Jay Roberts – Head of Investment Solutions & Products, RBC Wealth Management Hong Kong, RBC Dominion Securities Inc.

Alan Robinson – Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Capital Markets, LLC

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Additional *Global Insight* authors:

Alan Weider – Analyst, Royal Bank of Canada Investment Management (U.K.) Limited

Andrew Maxwell – Analyst, Portfolio Manager, Royal Bank of Canada Investment Management (C.I.) Limited

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