COOL, CALM AND COLLECTED INVESTMENTS

How to take the emotion out of investing

CONTENTS

Introduction	**4**
Five ways emotions can lead to bad investment choices	**6**
How can you avoid the pitfalls of emotional investing?	**14**

INTRODUCTION

It's a lovely, sunny day. You're in a great mood. Business is booming. Maybe you've even been listening to your favourite feel-good music. Could this be the right time to take a new look at your personal investments and make some serious decisions?

Almost certainly not.

When it comes to money, emotions – even positive ones – can lead to bad choices. A recent study[1] showed that when markets are rising fast, excited investors are more likely to buy without asking questions, pushing prices higher. This can lead to market bubbles – and we all know what happens to them.

As well as prompting what was once famously called 'irrational exuberance', emotions can make you over-cautious, too. Another study[2] revealed that people who were unable to feel emotions because of brain injuries made more money than those with normal brains, because they were less fearful.

So what's the prudent investor to do? Most of us are, to varying degrees, prey to our emotions. Money itself is a pretty emotive subject: it's intimately linked to all of our life goals. And because it involves taking a risk, investment is always going to bring your emotions into play, which could lead to you to take more – or perhaps less – risk than you need.

You can of course choose to outsource the whole business of investing to someone like Moneyfarm. Even if you do this, it's worth being alert to the pitfalls of emotional investing so that you always take a cool-headed and ultimately more profitable approach.

This ebook is your guide to taking the emotion out of investing.

FIVE WAYS EMOTIONS CAN LEAD TO BAD INVESTMENT CHOICES

Have you ever been tempted to follow the herd? To hold on to a falling asset for too long? If so, you've let your heart rule your head, which – as we're going to explore – can be a dangerous thing in investment. A discretionary service like Moneyfarm's can help you avoid these pitfalls.

1. JUMPING ON BANDWAGONS

In everything from politics to investing, majority opinion is very influential. No one wants to miss out on the next big investment opportunity. When you're driven by the powerful desire to get the best returns, it can be very tempting to follow the crowd that's flocking to the latest hot stock. In fact it can feel reassuring to know that you are making the same decision as everyone else.

The problem is, of course, that crowds are not always safe places to be. Are you following everyone to the goldmine? Or over the edge of a cliff? A classic and frequent example of emotional investing, the bandwagon effect has a tendency to seriously cloud people's judgment. It's been credited with contributing to the market crash of 2008, when investors simultaneously dumped the same asset classes.

During the 2007-2008 financial crisis, investors panicked simultaneously, selling their positions and helping to drive the market off a cliff. In the US alone, a staggering $8 trillion was wiped off the value of citizens' savings and investments, slashing their collective net worth by 25%.[3]

Countering the bandwagon effect needs courage, though. It's difficult to be prepared to zig when everyone else is zagging. Nevertheless, when there's a stampede in the market it's always worth taking some cool-headed time out to understand in depth what you might be getting into. Jumping on a bandwagon can often be the beginning of a downhill journey.

2. THE DISPOSITION EFFECT

When you sign up to Moneyfarm, our behavioural questionnaire helps us learn about your risk tolerance so we can select the ideal portfolio for you.

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Most of us love to win and hate to lose. But when this idea is transferred to investing, it can actually have a negative effect on your portfolio. The reason is something called the "disposition effect". This is the tendency of investors to hold on too long to assets that are decreasing in value, and to be too quick to sell assets that are gaining value.

Why do we behave this way? It's because we like to cash in our gains but are less willing to realise our losses. On the face of it, this is a sensible strategy. You've made some money: now you want to get your return. But from a finance perspective, it's irrational behaviour. The decision to sell or hold an asset should be based on its perceived future value, not the price you paid for it. Imagine how you'd have felt having got out of Google stock after you'd doubled your money on the $85 IPO price: 10 years later the price had risen 1,500%. That's a missed opportunity on a large scale.

According to a paper published in the Journal of Finance[4], we evaluate our investments in terms of gains and losses, and not the final wealth level. This tendency is linked to our attitude to risk. If you're risk-averse and your asset's value has risen, you're more likely to sell. Conversely, if you're more comfortable with risk, you may be liable to hold a stock that has decreased in value in the hope that it might rise again.

The disposition effect is stronger in people with a lower understanding of investment. This is not surprising. If you're not confident of your facts and strategies, it's harder to act counter to your own natural psychology.

In the short run, the market is a voting machine, but in the long run it is a weighing machine.

Benjamin Graham

3. FAMILIARITY

"Better the devil you know". We're all creatures of habit, so we are inclined to stick with familiar investments. However there's another famous maxim that underlines the limitation of this approach: "If you always do what you've always done, you'll always get what you always got."

Out there in the modern investment world, there will inevitably be some new investment vehicle or opportunity that you don't know about, or don't know enough about. You don't necessarily need to make a major switch in order to benefit from it – just diversifying your portfolio into asset classes beyond your usual choices could bring both opportunity and greater risk protection if chosen carefully.

The founding father of modern portfolio theory Harry Markovitz describes diversification as "the only free lunch in investing". A 2016 analysis published in Investor's Chronicle showed that a mix of exchange-traded funds (the main investment vehicle used by Moneyfarm) provided a relatively easy way to create a diversified portfolio that performed well.[5]

At Moneyfarm, we believe that investors get the best returns when portfolios are diversified, matched to their risk tolerance and regularly rebalanced to reflect market changes.

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4. OVERCONFIDENCE

Think you can beat the market? Think again. Your attitude isn't unusual, but your belief is unrealistic. It's a very rare skill to be able to earn better returns than the market: this is why people will pay millions of dollars just to have lunch with legendary investor Warren Buffett. Overconfidence in your investment ability is more than likely to land you with an underperforming investment.

> The most important quality for an investor is temperament, not intellect.
>
> *Warren Buffett*

Like drivers, most investors think they are better than average. According to one study, they overestimate their performance by up to 11.5% per year.[6]

5. ANALYSIS PARALYSIS

So you've overcome the four emotional pitfalls we've already talked about, and you're taking a serious, analytical look at your portfolio. Trouble is, where do you stop analysing and start making decisions? The sheer wealth of data, research and insight available today can be overwhelming. Even among the ETFs (exchange traded funds) that Moneyfarm currently focuses on (and which are designed to simplify investing), there are now myriad choices. ETFs cover global markets from cash to government bonds, equities, commodities and high-yield credit. We analyse and select them using a range of criteria including quality of provider, product liquidity and tight bid/ask spreads.

As an investor you need to be in control of your analytic technique as well as a master of your own emotions.

> The simpler it is, the better I like it.
>
> *Peter Lynch, legendary investor*

At Moneyfarm, we believe that our focus on diversified portfolios helps to protect against market volatility.

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HOW CAN YOU AVOID THE PITFALLS OF EMOTIONAL INVESTING?

BE CLEAR ABOUT YOUR OBJECTIVES

What are you trying to achieve with your investment? This should be the first thing to consider before you start. Thinking about your goal and when you will need to access your money is a useful way to cut through ‘analysis paralysis’. It helps you to narrow down both the range of possible investments and the time horizon. Setting a minimum investment level also makes matters simpler because it will automatically rule out particular investment options.

The Moneyfarm team puts decades of experience across wealth management and financial markets at your disposal.

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MAKE OBJECTIVE CHOICES

Focusing on specific, important criteria helps to cut through both the complexity of the market and any emotional “noise” so you can get to issues that really matter. For example at Moneyfarm, we choose ETFs as our main investment vehicle because they give our customers the same asset-class exposure as mutual funds but are more cost-effective. And because they are traded like a stock, the price is completely transparent.

When we decide which funds to invest in, the key questions on our mind are:

- What’s the quality of the fund provider?
- Do they have a high level of total assets under management?
- How liquid is their product?
- Are bid/ask spreads tight?
- Is the management fee low?

BE SELF AWARE

As we've seen with the "disposition effect", it's easy to let short-term movements influence your investment decisions. Retail investors tend to undervalue stocks that have recently fallen while overvaluing those that have recently gained. A good question to ask yourself is: "would I have done things differently if the opposite had happened?" If the answer is yes, then you are falling prey to the disposition effect and letting short-term bias control your decision.

It's important to remember that an investment is part of your medium to long-term financial plan. In the 1980s, founders of behavioural economics Werner de Bondt and Richard Thaler found that stocks that were considered "losers" outperformed those that had previously been considered "winners" after 36 months.[7]

We constantly watch the markets and rebalance your portfolio when necessary to optimise returns and manage risk.

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DON'T PANIC

Money flows fastest into the investment market just before a crash and slowest just before a big upturn in prices. This is the "bandwagon effect" in action. However if investors were making the best decisions, the opposite would be true. When markets are moving fast, emotions take over and people additionally fall prey to "confirmation bias", only looking for information that supports a preference they have already made.

It's important to know what's happening in markets. But when there are sharp movements up and down, this is not necessarily a trigger to buy or sell when your investment is for the longer term. So don't panic. Take time to review what's happening and keep your investments in perspective.

Also, there's never an "ideal" time to invest. While you may hope that a flat market rises or regret that you just missed a boom, investment choices should be made with a longer horizon in mind. Trends show that over time, whatever the market is doing, investments are more likely to beat inflation than cash and that's their real job: protecting the value of your hard-earned money.

> Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves.
>
> *Peter Lynch*

OUTSOURCE THE DECISIONS

One guaranteed way to take most of the personal bias out of investing is to use a discretionary investment manager like Moneyfarm. We use a questionnaire to understand your preferences and objectives, and then create an investor profile that's appropriate to them. Your investment decisions are then made by a team of experts working on your behalf. If you're an experienced investor then it's possible that this approach doesn't give you the control that you might be accustomed to. But for many people, it's valuable to have investments managed by a team that watches the markets and also has plenty of experience analysing past trends.

With this approach to taking the emotion out of investing, the only decisions you have to take are which investment manager to choose, and when to start investing.

> The four most dangerous words in investing: 'this time it's different.'
>
> *Sir John Templeton*

We believe that investors should have access to all typical markets: bonds, equities, commodities and currencies.

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ABOUT MONEYFARM

Moneyfarm is a digital wealth manager, we provide low-cost, diversified portfolios focussed on long-term returns. Since 2012 we have been paving the way in smarter investments. The company led by Paolo Galvani and Giovanni Daprà, is growing rapidly and has more than 70,000 active users. Our mission is to empower individuals to manage their wealth in a simple and efficient way.

You have worked hard for your money.

Moneyfarm understands that you are investing your hard-earned cash with us and you want to ensure that your money is secure. That is why our investment strategy will always start with capital preservation, we do not take unnecessary risk with your savings.

Achieve your life goals.

Your money is there to pay for your child's wedding, that dream sabbatical or your retirement in the sun. Moneyfarm's investment strategy works on your long-term returns to help you realise those dreams.

You need to get the most out of your savings.

With record low interest rates and inflation it is hard to grow your money when keeping it in cash. You need a new way to save with a strategy that takes on the appropriate level of risk. Moneyfarm constantly innovates to ensure you have the best wealth-management solution at the touch of a button.

You need to understand what is happening with your money.

When you are saving for the long term you need to understand the costs, the investment strategy and the way your provider works. That is why our advice is totally unbiased and we do not receive any back-end fees on the funds we select for your portfolio. Our cost structure is low-cost and simple to limit the impact on your returns.

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RISK WARNING

By making an investment, your capital is at risk. The value of your Moneyfarm investment depends on market fluctuations outside of our control and you may get back less than you invest. Past performance is no indicator of future performance. The tax treatment of a Moneyfarm Stocks and Shares ISA depends on your individual circumstances and may be subject to change in the future. You should seek financial advice if you are unsure about investing.

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