Don’t Let Your Emotions Cloud Investment Judgment

Ah … the good old days when an investor would pay anything for a pre-construction condo in Boca Raton. Why? When finished, the condo would presumably be worth a quarter of a million dollars more and you’d carry it with borrowed money.

Wrong, in most cases. This has been a painful lesson for many people.

One of the more common behavioral mistakes that investors make involves euphoria. Nick Murray, author of *Simple Wealth, Inevitable Wealth*, says this is more than greed – people get completely blissed out and lose all sense of danger.

A definition of risk is the chance that an investment will lose value. When you reach out for higher and higher returns because someone else is getting them – and you forget that higher returns means taking more risk – you have entered the euphoria zone. You have been blinded to the fact that risk rises along with price.

According to Murray, panic – another behavioral mistake – follows, and sometimes accompanies, the euphoria stage. The higher the euphoria, the deeper the panic or capitulation. When prices start to fall, you lose composure and believe your investment price will never come back. You have to get out at any price.

If panic overtakes you, you'll need to make two decisions:

• First, you must decide when to sell.

• Second, you must decide when to get back into the market.

Your odds of being right on both decisions are very low.

We make other behavioral mistakes as well, says Murray. They include:

• Under-diversification – This involves the often costly narrowing of a portfolio to essentially one idea. This can be a sector (example, technology stocks) or a company. If you work for Bear Stearns and invested the majority of your assets in the company stock, you found out the hard way of under-diversification.

"When you own one idea, all the lights go out and … pretty quickly," says Murray.

• Over-diversification – This is when you dilute your investment value by trying to own everything. The root of this mistake is the inability to make choices. The solution is to focus a portfolio with a finite number of meaningful investments.

• Making portfolio decisions based on your cost basis – This means you let your cost basis dictate an investment decision just to avoid paying capital gains taxes.
This is seldom prudent. When you let taxes drive the decision, you are bound to crash.

- Investing for yield instead of total return – This is the great behavioral mistake of the American retiree. Many go into retirement mistaking current yield as the only source of income. They end up buying a lot of bonds and not a lot of equities. The recent volatility in the bond market has surprised many investors.

Today, when we go to the gas pump or grocery store, we know costs are rising. According to Morningstar, the compounded annual return (after taxes and inflation) from 1929 to 2007 for large stocks was 5%; for long-term government bonds, 0.4%; and for 30-day Treasury bills, -0.7%.

The great long-term financial risk isn’t loss of principal, but erosion of purchasing power. Many of us greatly overestimate the long-term risk of owning stocks, and more insidiously, underestimate the long-term risk of not owning stocks.

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