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The psychology behind risk and investing

PART 1

Did you know that people are more likely to make rational decisions about money when it isn't their own? Perhaps you've had friends and family insist they know how should spend your bonus cheque, or what car to buy, or which area to look for houses in. Sound familiar?

This isn't just because of an annoying tendency to offer unwanted advice. It's also because when a decision doesn't have consequences on our own lives, we tackle it with less emotion and more logic. Understanding this can help you make a clear decision when navigating volatile financial markets.

THE OTHER F WORD

FEAR can be one of the biggest drivers of financial volatility. Markets rely on investor sentiments, and when the instinct is fear, share prices can fluctuate very suddenly.

Nobel Prize-winning psychologist and economist Daniel Kahneman suggests that fear-based decisions can be highly unreliable. When we react instinctively or in the heat of the moment, we can't always process that a threat is unlikely or even close to zero probability.

! **Be aware** if your primary motivation to invest/disinvest is fear, as you may find yourself neglecting important information like statistics, facts and figures.

ANCHOR MANAGEMENT

Investment experts are held to extremely high professional standards. The figures they produce and project can determine the entire trajectory of investment portfolios.

It is because of having qualified historical information from experts that we can remain anchored in realistic expectations for returns.

Between 1700 and 2010 the return on equities was 7% per annum, 5% on property and 4% on bonds. When you know this, you are equipped to be sceptical of the Next Big Thing offering 25% returns.

! **Without** anchoring facts and data, our ability to take calculated risks is compromised. Be sure your decisions are based on reality at all times.

CRISIS AVERTED! OR…?

Loss aversion refers to the fact that most of us prefer to play it safe. For example, research has shown that if you ask an individual whether they would take a R100 bet with 50-50 odds, most of us wouldn't. This is the case even though our lives wouldn't be drastically altered by winning or losing.

In the world of stocks and bonds, this causes investors to overstate losses relative to gains, leading to flawed investment decision-making. Investors become irrationally afraid of risk, which can make them miss prime investment opportunities.

! **Your investment** portfolio should be based on your risk profile, especially your number of years to retirement. Risk, when taken at the right time and in the right amount, is not a bad thing.

Staying aware of potential psychological traps may be tricky, but you can do it! Understanding and recognising that these habits exist and can influence your decisions is the first step.

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