Scotia Funds™

Pitfalls of emotional investing

Investment Insights

Avoiding common pitfalls of emotional investing

Everyone likes to see their investment do well. In fact, getting caught up in the momentum of a good investment when it is doing well can be quite fulfilling.

On the other hand, investing can be overwhelming. There are many variables to consider when making investment decisions: What are the markets going to do in the future? What are they doing now? What types of investment products should I invest in? In what specific securities should I invest? How much should I invest? How long should I stay invested?…and so on. The questions are endless, and it seems that the more we try to figure out all of the answers, the more overwhelming it can become.

On the next couple of pages we are going to share with you a few of the most common pitfalls that investors make with their investment decisions - ones which can significantly derail your long term investment plans. This behavior is known as "Emotional Investing". With patience and a sound financial plan, your investment advisor can help you avoid these common mistakes, and help your investing experience be a rewarding and profitable one.

8 Common investing mistakes

1 Short sightedness

Investing in mutual funds should never be a short term strategy. When initially investing in a stock or mutual fund, you likely have expressed to your advisor a time horizon in which you are comfortable staying invested. So why does it matter when that investment underperforms in the short term? Performance is reported on a quarterly basis, in some cases even more frequently - making it difficult to ignore the short term ups and downs in performance. Stick with your initial investment horizon and look at your investment as a long term strategy, and remember the rationale behind the investments you chose in the first place. Chances are, those reasons have not changed, and if they have, it's time to speak to your Advisor about making necessary changes to your portfolio.

2 Chasing winning performers

No one wants to miss out on a great investment. However, by the time you learn about it, odds are it's too late. Once a stock has done well enough to hit the media, everyone else has already heard about it too, driving the price up. The same can be said of a particular sector or asset class; by the time it has hit stardom status it may be on its way out, making room for another winner. The bottom line is: If an investment was doing well yesterday, last month, or even for the past couple of years, that was probably the time you should have invested in it - not today.

Pitfalls of emotional investing

3 Reaching for Yield

Not all fixed income investments are necessarily "safe". An investment in a bond is only as good as the ability of the underlying issuer (i.e. the company, municipality, government) to repay that obligation. For this reason, investing in bonds or other securities that are riskier in order to benefit from a few extra points of yield can be a losing gamble. Rule of thumb: If it seems too good to be true, there is a good chance that it is.

4 Putting all your eggs in one basket

No one particular market or investment will always perform well on an ongoing basis. History has shown that yesterday's winners may be tomorrow's losers. Therefore it is important to ensure that your portfolio is well diversified, with a variety of investments that offer different features and characteristics from each other. These nuances will help to provide balance in your portfolio as investments respond differently to changing market conditions. Investors tend to pick asset classes or investments that they like, but the market will do what the market will do, regardless of what 'you may happen to like'. Diversification will help your portfolio ride out these fluctuations.

5 Not rebalancing

Similar to not diversifying your portfolio, not rebalancing can be just as detrimental to the success of your investments. As asset classes outperform, the weighting of those classes will increase within your portfolio. Subsequently, the other asset classes will take an underweight position. Rebalancing means selling off a portion of the overweight asset classes and purchasing more of the underweighted classes, in order to bring the portfolio back to the original target allocation that your advisor helped you determine was right for you. This is tough for a lot of investors because it is not natural behaviour.

6 Falling in love with a story

The media does a great job of winning over investors by telling a great story. The charm and appeal of a heart-wrenching story can cloud judgement, masking poor fundamentals found in the numbers and through closer analysis. What you won't hear in the story crafted by the company's marketer or public relations officer, is that the stock is currently overpriced, or that it is experiencing poor management, is discontinuing a product line, has decided to cut it's dividend, or has other internal flaws not yet made public. A company may be a 'dud' or it may be great, and if it is great, it still may not be a fundamentally good investment. Professional money managers (such as your mutual fund portfolio manager) have access to tools and resources that you do not, and they are better equipped to make such decisions.

7 Listening too closely to the media – 'white noise'

There are a lot of 'experts' who have a lot of opinions and advice to give on what you should and should not own. Keep in mind that they rely on different sources of information and the information that you hear on the news or read in the newspaper is never the full story. More importantly, just because a stock is doing well, or a company is showing promise, does not necessarily make it a good fit for your portfolio. Only your advisor, who is aware of your investment objectives and risk tolerances should make recommendations for what you should hold. The media creates a lot of 'noise', and with noise comes distraction, making it easier to steer your investment plan off course with ideas that can develop into emotional investing behaviours. Rely on the sound advice that your advisor has for you. When it comes to the media, it can be a great tool but it must be handled with care.

Pitfalls of emotional investing

8 Common Investing Mistakes - Summary

1. Short sightedness
2. Chasing winning performers
3. Reaching for yield
4. Putting all your eggs in one basket
5. Not rebalancing
6. Falling in love with a story
7. Listening too closely to the media
8. Not having a financial plan in place!

8 Not having a financial plan in place!

Investing without a plan can be compared to going on a road trip without a map - you could be going in the wrong direction. It is important that you find an advisor with whom to share your goals and objectives, risk tolerance, investment horizon, current financial situation, future cash requirements, and just about anything else you may not think is important. What you may not consider important information could make a big difference in the financial plan that your advisor determines is best suited to meet all of your goals. Based on the information you provide, the plan that your advisor creates for you will address the best asset classes in which to invest. Your advisor will also ensure that you are adequately diversified, that your portfolio is rebalanced back to the target allocations, and the appropriate benchmarks for tracking success are set. Most importantly, you have their support to ride out market fluctuations. By trusting your advisor and following his or her advice, you can block out a lot of the ‘white noise’ and rest assured your investment plan is in good hands.

Legal disclaimer

Important information concerning the investment goals, risks, charges and expenses of investing in mutual funds is contained in the relevant prospectus or unit trust offering circulars. Investors should carefully consider these before investing. Copies are available from the financial institution where you are buying the mutual fund and should be read carefully before investing. Commissions, management fees and expenses all may be associated with investing in mutual funds. Mutual funds are not guaranteed or covered by your local deposit insurance corporation, other government deposit insurer, The Bank of Nova Scotia, or its subsidiaries/affiliates. Their values change frequently, including the amount of income that you may receive (where applicable), and you may not get back the original amount you invested. The foregoing is for informational purposes only and is subject to change without notice. Always consult your professional tax and legal advisors with respect to your particular circumstances. Nothing herein is intended to constitute an offer or solicitation to transact business for products or services in any jurisdiction where such an offer or solicitation would be unlawful. This does not constitute an invitation to purchase or sell shares of the Funds. ™ Trademark of The Bank of Nova Scotia, used under license where applicable.