12 Steps to Drive Emotions Out of Investing Decisions

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There is a large body of research showing that investors depend on emotions and anecdotal information when making decisions. You are no doubt aware of this and are familiar with the resulting cognitive investment errors. There have been numerous articles dealing with how investors can avoid such errors and, as a result, do a better job of managing investment portfolios.

Unfortunately, industry professionals apply techniques and put policies in place that encourage investors to continue making emotional decisions. So even if you want to drive emotions out of the investment process, the industry is set up to encourage you to do otherwise.

One solution is presented by Tom Howard, former finance professor and CEO of AthenaInvest Inc., in his book "**Behavioral Portfolio Management: How Successful Investors Master Their Emotions and Build Superior Portfolios**" (Harriman House, 2014).

Howard devised a classic 12-step program to show you how to ruthlessly drive out emotions and thus make it possible for you to make superior investment decisions.

Step 1: Hello my name is ________ and I am an emotional investor.

Like any self-help program, this one starts with admitting there is a problem. That is, you recognize that you make emotional investment decisions and you would like to avoid this going forward.

Step 2: It is OK to be wealthy.

This may seem like an unusual step, but many people don't believe they can be wealthy. Not only is it OK to be wealthy, but for many of us, it is also possible to be wealthy.

Time, discipline and a narrowly defined equity strategy are the keys to successfully building wealth. If it is possible for you to be wealthy, then don't apply emotional brakes that will prevent you from becoming so.

Step 3: I will strive to eliminate my myopic loss aversion and reduce my need for social validation.

The two most important emotional brakes are myopic loss aversion (MLA) and social validation, which are the result of millions of years of evolution. The fight or flight reaction triggered when a saber-toothed tiger showed up was critical to our survival as humans. However, a sudden drop in portfolio value can trigger the same MLA emotions as did that predator thousands of years ago, but without the same life-or-death consequences. So being governed by an ancient set of emotions often leads to poor financial decisions.

Doing the same thing as everybody else, the definition of social validation, also made sense thousands of years ago when life was full of danger. Since we lived in small groups then, we depended on others to sense danger and react instinctively. You didn't want to be the slowest member of the group when fleeing the tiger. In contrast, today we frequently want to take positions different from the emotional crowd as a way to harness the price distortions resulting from collective behavior.

Step 4: I believe that volatility measures are largely measures of emotion and should not be used in constructing and evaluating portfolios.

Volatility is driven by the emotional reactions to current events. Consequently, very little of stock market volatility can be explained by changes in underlying fundamentals. On the other side of the coin, investors react emotionally to volatility, meaning that emotions both cause and are caused by volatility. Volatility measures should be taken out of the portfolio management process to the greatest extent possible.

Step 5: I believe that volatility and risk are not synonymous and that most references to risk are really references to emotion.

Risk is the chance of underperformance while volatility is a measure of emotion. For short-horizon portfolios, volatility does contribute to risk. For long-horizon portfolios, volatility plays a much-reduced role. Since portfolios are often built based on short-term volatility, the paradoxical result is that risk is actually increased. This happens because reducing short-term volatility often reduces long-term expected return, which means the chance of underperformance has increased.

A classic example of this is investing in both stocks and bonds in a long-horizon portfolio in an effort to reduce short-term volatility, with the result that it is virtually guaranteed you will underperform a 100% stock portfolio over the long term.

Risk is mentioned frequently in market commentaries and portfolio analysis, but most of the time emotion is what is being referenced, not risk.

Step 6: I believe that increased stock market volatility represents an opportunity for, rather than a risk to, my portfolio.

Stock market volatility is particularly problematic when making investment decisions. As market volatility increases, the reaction hardwired by evolution is to exit. Since so many investors do exactly this, a behavioral price distortion results.

Research shows that following a period of heightened market volatility, above-average market returns are common. The historical average market return is 10%, which means expected returns exceed 10% after a period of excess market volatility. The typical investor switches into fight-or-flight mode, exits the market and misses the above-average returns. Studies confirm that the typical equity mutual fund investor underperforms the return of the fund since fund purchases and liquidations are poorly timed.

Step 7: I will divide my portfolio into buckets as a way to reduce emotional sensitivity to volatility.

Dividing up a portfolio into buckets, each meeting a different set of investor needs, is an important step for reducing the emotional impact of volatility. Typically the portfolio is broken into three buckets.

The first bucket meets liquidity and short-term income needs and is funded using liquid, short-term, low-to-no- volatility instruments. The goal is to eliminate concerns regarding volatility, and the result is confidence that short-term needs are being met. The issue of volatility has been removed from this portion of the portfolio.

The second is the capital growth bucket for building long-horizon wealth. It is important to structure your analysis to spend as little time as possible on the short-term performance of this bucket in an attempt to maintain a long-term focus. If this can be done successfully, it is more likely that long-term expected and excess returns will be the focus for building the capital growth portfolio and, in turn, there will be little focus on short-term volatility and correlations.

The third bucket is composed of unique investments requiring special management. Such investments include real estate, farms, art, a stock held for non-performance reasons, and other non-traditional assets. These are managed in a unique way based on your personal preferences.

Breaking a portfolio into buckets is an alternative to the traditional 60/40 portfolio approach. Each bucket meets a specific need, as opposed to constructing a single portfolio to meet overall needs. This divide-and-conquer approach can have a positive impact on performance while reducing the emotional impact of portfolio volatility. It is one of the most effective ways for driving out emotions.

Step 8: I will focus on expected and excess returns, while largely ignoring correlation and volatility when building long-horizon portfolios.

If a portfolio is divided into buckets, it is easier to focus the capital growth bucket on long-term expected and excess returns. This also provides an opportunity to largely ignore correlation and volatility, which help in dealing with myopic loss aversion, mentioned earlier, but have little or no positive impact on long-term performance.

Investors who successfully implement the bucket approach generally hold little or no fixed income in the capital growth bucket, thus avoiding the negative impact of low expected bond returns. Instead, fixed-income investments are limited for use in the liquidity and short-term income bucket. This is the power of the bucket approach and allows for constructing separate parts of the portfolio very differently. Being able to ignore volatility in the capital growth portfolio is highly favorable for building long-term wealth.

Step 9: I will forget the price I paid for an investment, as well as its name, to mitigate these emotional anchors.

It is easy for individuals to anchor on a piece of information, even an arbitrary piece of information that has little to do with the investment itself. The price paid is an anchor that impacts subsequent decisions. It is the starting point of many an investment rule, such as stop-loss orders, profit harvesting based on X% price increase, and holding a stock until it gets back up to the price paid. This latter rule is obviously emotional, as are the other two, which is a consequence of myopic loss aversion.

Purchase price rules are used by so many investors that it is believed it produces market-wide price distortions, referred to as the disposition effect. This effect posits that investors sell winners too soon because of the emotional validation arising from earning a positive return, while hanging on to losers too long, due to loss regret.

Reinforcing the disposition effect is the observation that investors fool themselves into thinking that if the stock is not sold it really isn’t a loss. The tax code, which does not recognize gains or losses until realized, supports this too, which is an example of even the IRS encouraging emotional investing. A straightforward way to avoid the pitfalls of the disposition effect is to forget the price paid.

The investment's name is another anchor that attracts information, whether useful or not. The key to successful investing is consistent pursuit of a narrowly defined strategy, which translates into making investment decisions based on a limited information set. This means ignoring everything else about the investment other than what is important in executing the strategy. An investment's name attracts a full range of information that you may have a hard time ignoring, particularly if it comes from what you believe is a credible source. It is only human nature to begin doubting your analysis. One way to avoid experiencing these doubts is to forget the name of your investments.

It's only natural that you enjoy talking about your investments. So when asked, you describe them with a sense of pride, since they were selected based on your careful and insightful analysis. The names you mention will trigger in your listener their own emotions and thoughts regarding the company. Often the person will not agree with you and explain why they feel the way they do, and you might begin doubting your decision. A simple way to avoid this problem is to tell people you cannot remember what you've invested in.

There is only one reason to buy stocks: to make money. They are not part of your family. If you conclude that a stock is no longer a good investment, sell it, forget it and move on. Do not fall in love with your stocks and don't think twice when you sell them. Investment management is a cold-blooded, return-maximizing endeavor.

Step 10: I believe past performance is a poor predictor of future performance, so I will not use it when evaluating an investment manager.

Past performance is not predictive of future performance. It is not like there is controversy surrounding this conclusion, as it has been confirmed by numerous academic studies. In spite of overwhelming evidence, virtually everyone, individuals and professionals alike, uses past performance in selecting managers. In fact, it is frequently the most important criterion when selecting a manager.

This is a dramatic example of the emotional power of the representativeness bias. If you release this emotion, you will be acting differently than virtually everyone else in the industry. Are you strong enough to do this? If you are, your portfolio performance will improve.

Step 11: I believe unreasonably constraining a portfolio, such as keeping a manager in a style box, hurts performance and thus will be avoided.

Consistent pursuit of a self-declared investment strategy is key to superior performance. Anything that gets in the way of doing this, such as emotions applied by an investor or constraints imposed by the industry, hurts investment performance.

One of the major offenders in this regard is the style grid used for active equity fund evaluation and distribution. One way to improve portfolio performance is to remove any requirement for a fund to stay in a style box.

Step 12: I will consistently pursue a narrowly focused investment strategy while taking only high-conviction positions when managing a portfolio.

Now that 11 of the 12 steps for removing emotions have been completed, you are ready to begin building an investment strategy. Successful strategies are narrowly focused on harnessing emotional crowd-driven price distortions by consistently pursuing the strategy over time and by taking high-conviction positions. These are important for building a superior portfolio.

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