ALASKA HIGHWAY NEWS

Brad Brain: The cycle of market emotions

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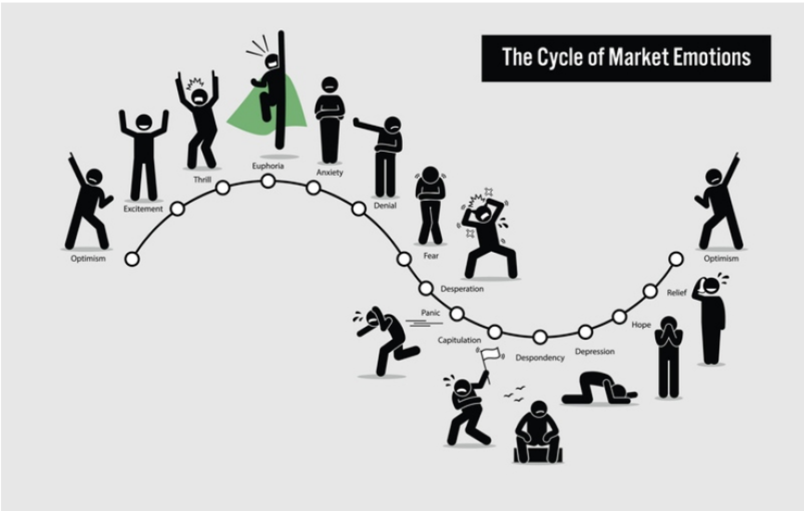
Smart Money



Brad Brain: "The cycle of market emotions corrodes your sound intellectual framework. Break the cycle!"
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Behavioural finance is the study of why people make the financial decisions they do. I often write about behavioral finance, and there's a reason for that. This is not just academic. Right or wrong, these are the real-life decisions that people make about money.

All the cognitive biases, errors of judgement, phobias, misperceptions, conspiracy theories, oversights, slip ups and all of the other stuff that goes into the decision-making process. That's behavioural finance. And we can learn a lot from studying these things.

For example, lets talk about the cycle of market emotions.

I imagine that almost all readers have heard the expression "buy low, sell high." As Will Rogers said, "Don't gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it."

Buying low and selling high is intuitively rational. But, often, that's not what people actually do. There's overwhelming evidence that many people seem to be hardwired to do just the opposite: to buy an investment after it has already appreciated only to sell the same investment if it goes down in price.

So why do people seem determined to do exactly the wrong thing – to sell when they should be buying, and to buy when they should be selling? It's because most people make money decisions based on emotions rather than logic.

The two dominant emotions that drive money decisions are fear and greed. These are not good mental states to be in when making decisions about your wealth.

What happens when an investment goes up in value is that people will feel better and better about it. They will start out optimistic. As the investment rises they will be pleased. As it rises further they will get excited, then thrilled, and then euphoric.

This is the point when people really want to buy in. People extrapolate the recent good performance as continuing uninterrupted, and they want a piece of the action.

Tell the truth, how many of you wanted to buy marijuana stocks a couple of years ago, after they had appreciated substantially? The only thing is, this doesn't sound very much like "buying low" does it?

Conversely, if an investment slumps people will feel progressively worse about it. At first, they might dismiss a decline as being inconsequential. They might be in a state of denial, but that's going to turn to frustration, then a feeling of helplessness, then anger. Often when things seem the absolute worst people will just get so fed up they capitulate, and sell off the investment to try something new.

Again, people are extrapolating the recent short-term performance as continuing without reprieve, and they make a decision based on that. The decision? Get me outta here!

Tell the truth, how many of you wanted to make some changes to your investments sometime in 2020, with its record-breaking market turbulence? Of course, this seems far-removed from the “sell high” concept.

Having a natural inclination to do the wrong thing seems like a pretty bleak situation. Fortunately, I have some great news. There is a very effective solution to this.

Diversification. Don’t have all your eggs in one basket. A properly diversified portfolio and the discipline to stick to your long-term investment strategy can get you off the buy high, sell low hamster wheel that is a consequence of the cycle of market emotions.

As Warren Buffett says, “To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”

The cycle of market emotions corrodes your sound intellectual framework. Break the cycle!

Brad Brain, CFP, R.F.P., CIM, TEP is a Certified Financial Planner in Fort St John, BC. This material is prepared for general circulation and may not reflect your individual financial circumstances. Brad can be reached at www.bradbrainfinancial.com.