

Emotion and Investing – Mixing Oil and Water

The key to successful investing is to limit your losses and protect your gains. Sounds easy enough, so why do investors cling to stocks that have declined even though they have little confidence that they will recover? In fact, studies show that investors are twice as likely to sell winning stocks to cover losses, than they are to sell the stocks that lost them the money in the first place.

It has to do with the ego in all of us. No one likes to admit to making a mistake by selling off, especially if it means realising a loss. This is only natural but it has the potential to be extremely destructive to investments. It promotes investing according to emotional whims rather than rational thinking.

These emotional investors are holding firmly on merely because after taking a horrible loss they are waiting, hoping that the stock will rebound to the price at which they bought it so they can sell without incurring a loss.

Perhaps they even buy more on the way down to “dollar cost average” their investment. The problem is that there is no guarantee if or when the stock will recover. Holding on because you’ve suffered a loss and want to “get even” before selling may only serve to put you further behind, forcing your money to work even harder to make up for lost ground.

Consider the following example. You purchase a stock at \$50 per share. Should that stock fall to \$40 you will have lost 20% of your investment, another 20% should it fall further to \$30, and half of your investment should it fall to \$25 per share.

Price Per Share	% Gain/Loss
\$50.00	0%
\$40.00	-20%
\$30.00	-40%
\$25.00	-50%

Now that your stock is only worth \$25, to recover a mere \$5 of the loss, the stock must rise in value by 20%. For the stock to recover to \$40, it must rise in value by 60%. To reach the break-even point, you must now make 100% on your investment. In other words, a 50% loss on an investment requires a 100% gain thereafter just to break even.

Price Per Share	% Gain/Loss
\$25.00	0%
\$30.00	20%
\$40.00	60%
\$50.00	100%

Let us assume that after 5 years, the stock does climb back to \$50. You might feel smart and self assured, comforted by the fact that at least you did not lose any money. This, of course, is not true. You tied up your money for 5 years and received nothing in return. If you left it idle in a bank account, you would have at least earned a little interest.

What you lost was the opportunity to invest your money in something that would have earned you a positive return. This type of loss may be less painful than suffering a capital loss, but it is still very real.

More money has probably been lost by investors holding a stock they really did not want until they could at least break even than from any other single reason. Furthermore, as an

investment goal, merely hoping to get your money back is not very ambitious and certainly not a very profitable way to invest.

It is easy to fall into this trap because a loss is a known value. The concrete nature of that finite number allows investors to sit on the loss because they have a benchmark they need to attain. A gain on the other hand is an unknown factor and it is hard to reach your destination if you do not know where you are going. This is why setting objectives for earning a return on your investment is so important.

What are your goals for this investment? Is it part of your retirement strategy? Can you afford to lose your money on this investment? If not, how much risk are you prepared to accept? Once you have carefully thought through your investment philosophy, defined your goals and established a strong set of rules for achieving them, you can minimise the influence emotions play on your investments.

The most experienced investors will tell you that the key to wealth-building and wealth preservation is to have a specific strategy for investing and apply that strategy in a consistent and disciplined manner. Unless you have a plan that you prepare in advance and commit to stick with regardless of what else is happening, emotions such as fear and greed can play havoc with your investing.

When it comes to selling stocks, an effective way of removing that irrational feeling from your decision-making process is to ask yourself whether there are any stocks you currently own that you would not buy today.

If you like your companies and are confident that they have good reasons to outperform alternative investments, a market correction may be a good opportunity to add to your holdings. If, however, you conclude that there is somewhere else your money would be better invested or spent but you are waiting for a recovery, you should consider selling. If you are unsure, then ask someone like your broker for help.

Selling one stock might not be done necessarily to put funds into another stock, though. It could be done to add money to a quality fund or other investment to diversify your portfolio. Either way, the money should move into something better that is earning you a profit.

In a diversified portfolio, another useful discipline to consider is selling half of any stock that exceeds 10% of the portfolio. It is the same rule often followed by mutual fund managers to limit their exposure, and therefore risk, to any one security. By periodically rebalancing and cutting back on positions that have grown to a large percentage of your portfolio, you can avoid the risk of a substantial hit.

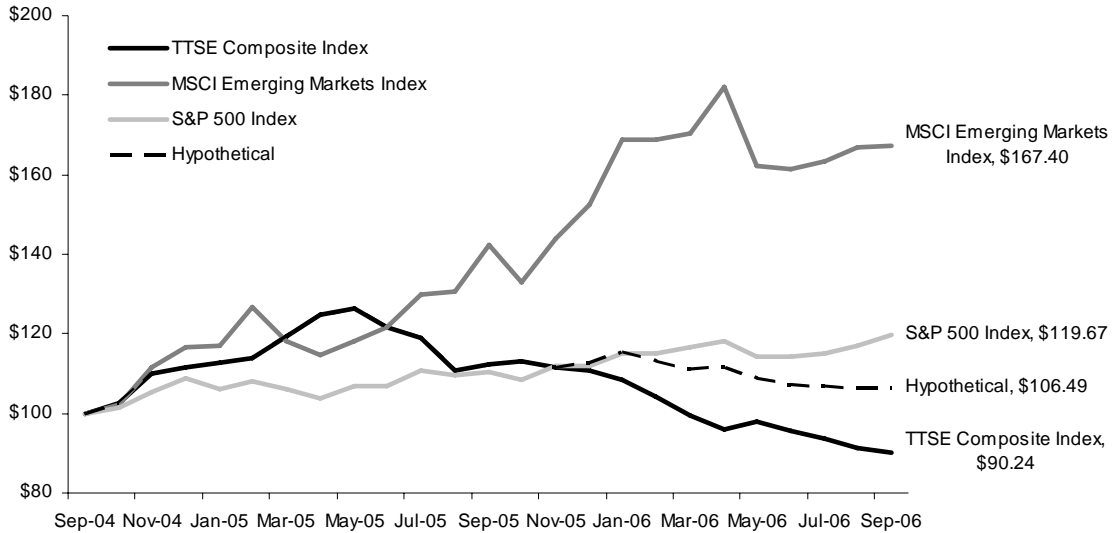
Considering recent history and the number of investors who suffered huge portfolio losses in the past several months, developing a discipline for selling stocks seems especially critical now as you consider your current position in the market.

There is a real danger in assuming that stocks will recover as quickly as they plunged. Before the local stock market's extraordinary rise and fall between August 2002 and 2006, the market was effectively flat over the previous four-year period. Conversely, the emerging markets returned almost 25% during the same period (between August 1998 and 2002), confirming the benefits of diversification and the potential opportunities clients can get in other markets.

Consider hypothetically that you had established a rule to sell any stock that fell below 10% to 12%. Using the TTSE Composite Index data and assuming an original investment of \$100 in September 2004, you would have sold your position in December 2005, six months after the market began its decent. Rather than applying a wholesale switch out of the stock, you cut half of your losses by liquidating 50% of your holding and investing it in equal proportions between the U.S. and emerging markets, represented by the S&P 500 and MSCI Emerging Markets Indices, respectively.

Despite realising a capital loss, your decision to invest the money in assets with substantially better prospects would have saved you from a 10% paper loss today had you decided to stick with the loser. In fact, the hypothetical illustration would be worth \$106 today instead of \$90. Had your initial investment been \$100,000 instead of \$100, the \$16 you would have forgone would amount to \$16,000. In other words, the more you have invested, the more it hurts to stick with a loser.

Cumulative return of a \$100 investment for the period Sept 2004 to Sep 2006



No one is going to deny that the local market will eventually bounce back and go on to new highs. If you believe a company's long-term prospects are still good and you can afford to ride out the storm both financially and emotionally, keep hold of it. Those investors concerned about their financial stability if the market does not recover over the next few years should consider changing their investment strategy right away. It is not worth waiting.

The key is to recognise whether your hard-earned money should be elsewhere by figuring out which stocks are mistakes and which represent opportunity. No one wants a loss, but if it happens, do not let your ego get in the way of making the right decision. Remember that emotion is the enemy of successful investing.