Psychology of investing

MARKETS CYCLE... EMOTIONS SHOULD NOT

The prices of financial securities (i.e., stocks, bonds and mutual funds) are typically determined by some varying combination of three driving forces: fundamentals, valuation and investor psychology. Prices generally follow a pattern akin to that shown in the chart. Psychological factors play a very important role in pushing asset prices to extremely elevated or depressed levels at the peaks or troughs of market cycles. Psychological forces span the gamut of human emotions often influencing investors to make misguided decisions. Removing emotions and staying the course can be key to better long-term performance.

Factors driving asset prices across market phases

Illustrative purposes only

Market phase	Bottom	Early stage recovery	Mid-stage bull market	Peak of bull market	Bear market
Fundamentals	Improving but ignored	Solid underlying performance	Strong growth	Optimistic, long-duration projections	Over-awareness of deteriorating conditions
Valuation	Attractive, but no takers	Abundant bargains	Willingness to pay up	Revised models justify stretching	Shocked recognition of outlandish prices paid
Psychology/ Technical	Exhaustion, disbelief & demoralization	Doubt, reflection & conversion	Faith & hope	Euphoria, greed & extrapolation	Fear, panic & loathing

Source: Darst, David M., *The Art of Asset Allocation*. McGraw Hill, 2003. Morgan Stanley (reprinted with permission)

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It would be prudent for many investors to review some of the key findings of "behavioural finance," which studies the way people make financial decisions. The traits listed below were particularly evident during the late 1990s and early 2000s, leading up to and following the technology bubble. Expert advice, the discipline of a well constructed financial plan and proven investment disciplines are key to helping investors manage their emotions and stay the course no matter what phase the market is in.

Key findings from behavioural finance

- Investors are **over-confident** and think they are better at making choices than they really are
- Investors believe in **winning streaks** and are impressed by short-term success
- Investors confuse familiarity with real knowledge, and **over-react** to both good and bad news
- Most investors are trapped in a **cycle of fear and greed**. When the market goes up they are desperate to make more, and when it falls, they become convinced it will never recover

Source: The Economist, July 5, 2003 (reprinted with permission)

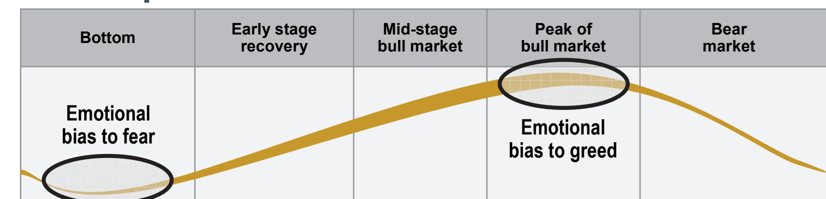
Words of wisdom from Warren Buffett

*"I buy on the assumption that they could close the market the next day and not re-open it for five years."**

*"Be fearful when others are greedy... and greedy only when others are fearful."***

Sources: * Omaha World Herald, July 31, 1983
** Berkshire Hathaway annual letter to shareholders, March 2005

Market phase



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Proven strategies to help reduce anxiety and improve long-term results

- It's important to stay focused on investing for the long term. History has demonstrated that markets have always cycled and rebounded to reach new highs. The key is maintaining a disciplined approach to investing
- A proven strategy is a "regular investment plan" with periodic contributions. Take advantage of dollar cost averaging, buy less units when the market is up, more units when the market is down
- At AIM Trimark, our investment management professionals adhere to time-proven disciplines designed to build and protect wealth over the long term
- Financial planning advice and professional investment management are important and powerful resources to assist investors to stay the course and reach their goals

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