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Breaking the Cycle of Emotional Investing: Strategies for Better Decisions

Emotions play a significant role in our decision-making processes, and when it comes to investing, they can have a profound impact on our ability to make rational choices. Emotions such as fear, greed, and overconfidence can cloud rational judgment and lead to irrational investment decision-making. In stocks market for instance, one of the most common emotional responses that affect investment decisions is the fear of missing out (FOMO), which can cause individuals to buy high and sell low. Some investors may cling onto lost stocks for a long time in the hopes that the price will rise if they are unwilling to cut their losses. While it is natural to hope for a rebound in stock prices, the reality is that some stocks may never recover, and waiting too long to sell can lead to significant losses.

This behaviour may be explained by loss aversion.

Loss aversion is a well-established concept in behavioural economics, with significant implications for investment decisions. It is a cognitive bias that refers to an investor's tendency to be more strongly influenced by the potential of losses rather than the potential of gains. This tendency can lead to emotionally driven investment decisions, as people may prefer to hold onto losing investments rather than sell them in order to avoid the pain of loss, even if selling would be the more rational decision for their portfolio. Ultimately, a person's capacity to make rational decisions is significantly hampered when they are under emotional stress.

The herd instinct hinders rational investing.

The term "herd instinct" refers to an individual's tendency to conform to the behaviours or opinions of a larger group. It can lead to irrational investment decisions like selling out of panic during a market drop or adhering to passing market trends. Instead of completing their own research or analysis, investors could be swayed by the actions of others, resulting in suboptimal investment decisions that are not aligned with an individual's financial goals or risk tolerance.

Insufficient research in investment is a risky action.

Investors who adopt a speculative mindset often base their investment decisions on instinct, emotions, and luck, without conducting thorough research and analysis. This can lead to significant gains or losses. On the other hand, successful investors focus on investments that have strong fundamentals and a high potential for growth, instead of relying on luck or intuition, which could put their hard-earned money at risk.

How to keep one's emotions out of the way?

Several techniques can be employed to prevent emotional decision-making. The most important is to remember that anxiety during turbulent market stretches is common and natural, and not something investors need to act on. Other useful strategies for minimising emotional influence on investments include:

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1) **Understand what you are investing and invest with fundamentals.**
   Investors must understand the nature and volatility of each asset class to make informed investment decisions. Equities are known for their high volatility, while bonds are generally considered to be less volatile. On the other hand, commodities, such as gold and oil, can be highly volatile, with prices being affected by factors such as weather conditions, geopolitical events, and supply and demand.

2) **Proper goal setting is the key.**
   Investors must understand their risk tolerance, time horizon, and investment objectives, as well as how these factors fit into their overall financial picture. By reviewing these objectives on a regular basis, investors can have an up-to-date guide for any significant portfolio adjustments. This could also serve as a reminder to be patient and resist the urge to react to short-term fluctuations in investments.

3) **Investors should invest with data, not emotions.**
   Investors can help to reduce the risk of losses and increase the likelihood of achieving their financial goals by adopting a disciplined and rational approach to investing. Furthermore, emotional responses can be mitigated through proper risk management, such as the use of stop-loss orders or the diversification of investments. A well-diversified portfolio with non-correlated asset classes can help reduce volatility and the emotions that come with it.

4) **Sufficient liquidity**
   Maintaining a sufficient cash reserve to cover living expenses for at least three to five years can offer a sense of security during market volatility. This approach helps to avoid the need to sell high-quality stocks at reduced values to meet current financial needs.

5) **Engage with a professional investment firm to assist with your investment decisions.**
   Engaging with a professional investment firm can offer a range of benefits, including access to investment opportunities, expert guidance, and comprehensive financial planning services, which can help investors identify and achieve their long-term financial goals.

Of course, the list is not exhaustive and there are numerous strategies available to help us minimise the impact of emotions on our investment decision-making process. **One effective approach is to incorporate quantitative methods into the investment process**, which brings several benefits and enhances decision-making. Quantitative methods in investing rely on data-driven analysis rather than subjective interpretation. They have the ability to identify patterns and trends that may not be easily observable to the human eye. By providing a systematic approach, quantitative methods help reduce the impact of emotions on investment decisions, resulting in a more consistent investment performance.

Quantitative models have demonstrated success in stock selection, with one notable example being the Dogs of the Dow model. The "Dogs of the Dow" is a quantitative investment strategy that aims to identify undervalued stocks for potential long-term gains. It is based on the concept of selecting the highest dividend-yielding stocks from the Dow Jones Industrial Average (DJIA), which is an index comprised of 30 large, blue-chip companies.

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The "Dogs of the Dow" strategy involves selecting a specific number of stocks, typically 10, from the DJIA. Once these ten "Dogs of the Dow" stocks are identified, an investor typically allocates an equal amount of money to each of them. The underlying rationale is that these high-yielding stocks, which are temporarily out of favour, have the potential to bounce back and generate attractive returns. The strategy aims to benefit from both potential capital appreciation and dividend income. By focusing on high dividend yields, the "Dogs of the Dow" strategy seeks to generate income through regular dividend payments. This income can act as a cushion during market downturns, providing some stability to the overall investment portfolio.

Please click on the link to learn more or email us at phillipmutual@phillipcapital.com.my if you require any further information.