

Behavioural investing

The pack mentality



The share market is characterised as having a personality of its own for good reason.

It is not made up of automatons making coldly logical pre-programmed decisions. It is comprised of investors – individual and collective – who often react emotionally and sometimes irrationally to good and bad news. Called behavioural investing, it is especially important to be aware of it during periods of market turbulence.

Hunting in packs

Many investors tend to 'hunt in packs', making investment decisions based on what the 'herd' is doing. The media tends to perpetuate this herd-like investing – printing sensational headlines that often exaggerate the reality of current market conditions.

On a bad day, shares can be 'savaged' or 'mauled' by an unforgiving share market, while on a good day, they can be 'rewarded' or 'boosted'.

Such headlines can often lead to 'bandwagon jumping' where investors react in panic by buying or selling particular shares. Blinded by this panic, rational consideration is not given to the true underlying value of these shares, or the strength of the company behind the shares.

It is important to remember that through behavioural investing, investors run the risk of potentially buying shares that are over valued, or selling fundamentally sound under-valued shares which have reached the bottom of the cycle and have a favourable earnings outlook.

Investors are prone to a wide range of emotional or psychological impulses, including:

Overconfidence

Trading too much or taking too much risk in one area

Loss aversion or fear of regret

Not taking action when necessary to buy or sell shares

Mental accounting

Holding an emotional attachment to individual investments

Anchoring

Placing too much credence in recent price movements and not enough in a share's long-term history

Procrastination

Not acting in their best interests due to inertia, investors can end up constantly worrying about selling 'winners' too soon and getting rid of 'losers' too late

Herd mentality

Over-reacting to every piece of bad and good news, investors can become too optimistic when the market rises and too pessimistic when the market falls.

Dotcom crash

What happens when the bubble bursts

The 'dotcom crash' is a prime example of how the irrationality of investors can create an artificial bubble, leading to an inevitable – and painful – correction. In the late 1990s, investors scrambled to buy shares in technology companies as excitement grew surrounding the potential of the Internet.

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As investors became entranced by the possibilities of online commerce, they signed up for every start-up 'dotcom' venture that tried its hand at an initial public offering without properly and objectively analysing the company's fundamental revenue streams and business plan.

They forgot to ask the basic question – how will the company make money?

Many of these technology shares were listed on the NASDAQ exchange, which enjoyed a phenomenal rise, improving more than fivefold in the space of five years.

But around the turn of the millennium, reality slowly began to dawn as more and more dotcom companies started to file disappointing returns and future earnings projections.

A sharp correction was inevitable. The index lost nearly 9 per cent in three days, precipitating a slow, steady decline which saw the NASDAQ bottom out at just over 1000 in late 2002 – just over a fifth of its peak only two years earlier.

Both the original spike in share prices and the eventual crash were out of proportion. They were driven by investor sentiment and the herd mentality, which artificially boosted the value of many shares way out of line with the modest earnings prospects of the dotcom companies.

But even the dotcom crash had a happy ending for long-term investors who resisted the temptation to realise their losses at the bottom of the cycle, with the NASDAQ index subsequently climbing gradually and more sustainably to its current level of around 2500.

Discipline is key

A disciplined approach to investing is the key to avoiding the potential pitfalls of a behavioural approach. By using rational thought rather than emotion, and by ensuring your portfolio is well diversified over the long term, you are more likely to see your financial goals achieved.

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