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Investor Behaviour

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A recent study by Dalbar, Inc. (a US research firm) concluded: "Investment return is far more dependent on investor behavior than on fund performance. Mutual fund investors who simply remained invested earned higher real returns than those who attempted to time the market". Between 1984 and 2004 the average Market Timer investor lost (-3.9%) per year. This data is for the US market.

Dalbar also reported that the average hold period for the average equity fund investor was 3.3 years.

A study by the research firm FundMonitor.com has suggested similar results for Canadian investors. For example, for the 10 years ending September 2002, the Fidelity International Portfolio Fund earned 9.6% per year, but the average investor in this fund lost (-0.1%) per year. The average investor in the Templeton International Stock Fund earned 1.4% per year while the fund returned 9.9% per year over the same time period.

Given that the average investor seeks the best-performing investments to suit their situation, shouldn't the average investor achieve at least the average investment return?

The answer is quite simple – it all comes down to investor behavior; investors do not always make the most rational decisions.

Investor behavior is characterized by overexcitement and overreaction in both rising and falling markets. The average investor has the tendency to purchase or increase their holdings in investments that perform the best in the short term. At the same time, these same investors tend to sell or reduce their holdings in investments that have performed poorly, again, in the short term. As a result, just prior to a market correction, the average investor will hold a portfolio that is heavily weighted in asset classes that have demonstrated the best short-term performance. Since a large proportion of monies have been added to these investments after most of the growth has occurred, this strategy leads to a dramatic decline in their portfolio when the market corrects.

During a stock market correction, investors tend to panic, believing that they will lose all or most of their money, and so he most common reaction is to sell to "cut their losses". This behavior drags the market down further than fundamentals suggest – it is a self-fulfilling prophecy. Ultimately this leads to a deeply negative sentiment about investing in general, and it is during these times that we hear statements such as "I should have left my money under my mattress", and Investing is like gambling".

By definition, in every portfolio, one investment holding will be at the "bottom" of the heap. Investors need to analyze their portfolio as a whole, rather than spending too much time worrying about individual investments.

To further complicate matters, the market does not, and will not, react in a predictable manner over the short-term. The important point to keep in mind is that these short-term stock market trends have nothing to do with the underlying investment climate.

> *Trying to predict short-term movements in the market means trying to predict investor sentiment, which is nearly impossible; it has nothing to do with the underlying value of the stock market in the long run.*

When adjusting your portfolio, you always want to make changes from a position of strength. The best time to make changes to your portfolio is during a rising market. Can you predict the best time to make the changes? Not likely, but you will be making these changes while you are in a profitable position.

This does not mean selling the investments you think are "dogs" (although sometimes you need to do this) and buying investments that have recently done well. This means selling a portion of the investments that have been profitable – you want to realize some of your profit.

It goes without saying that investors need to take the time to understand their personal risk tolerance before investing. Spending the time to understand your risk tolerance is one of the most crucial steps to successful long-term investing.

If you invest in a portfolio that is too aggressive for your liking, then during the inevitable stock market correction, you will be tempted to make changes to your portfolio, thereby guaranteeing yourself a loss. It appears to be human nature to make changes during declining markets.

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The investment industry spends a great deal of time talking about asset classes, investment managers, investment strategies and management expense ratios, etc. Despite all of these discussions, the most important step in a successful long-term investment strategy is dealing with investor behavior.

You should endeavor to develop a long-term investment strategy that takes into account not only your risk tolerance, but also your goals and objectives. After all, the reason for building an investment portfolio in the first place is to meet your various financial goals and objectives throughout your lifetime. Thus, it is essential to spend the time developing a personalized Investment Plan designed and implemented for your specific situation. This investment strategy should be used to guide your portfolio both in rising and falling markets.

In summary, allowing your emotions to guide your investment decisions is a no-win situation. Focusing on short-term market fluctuations will likely achieve nothing more than a much lower rate of return than if you had done nothing at all. Instead, look to your personal plan to guide your investment decisions.

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