RBC Global Asset Management

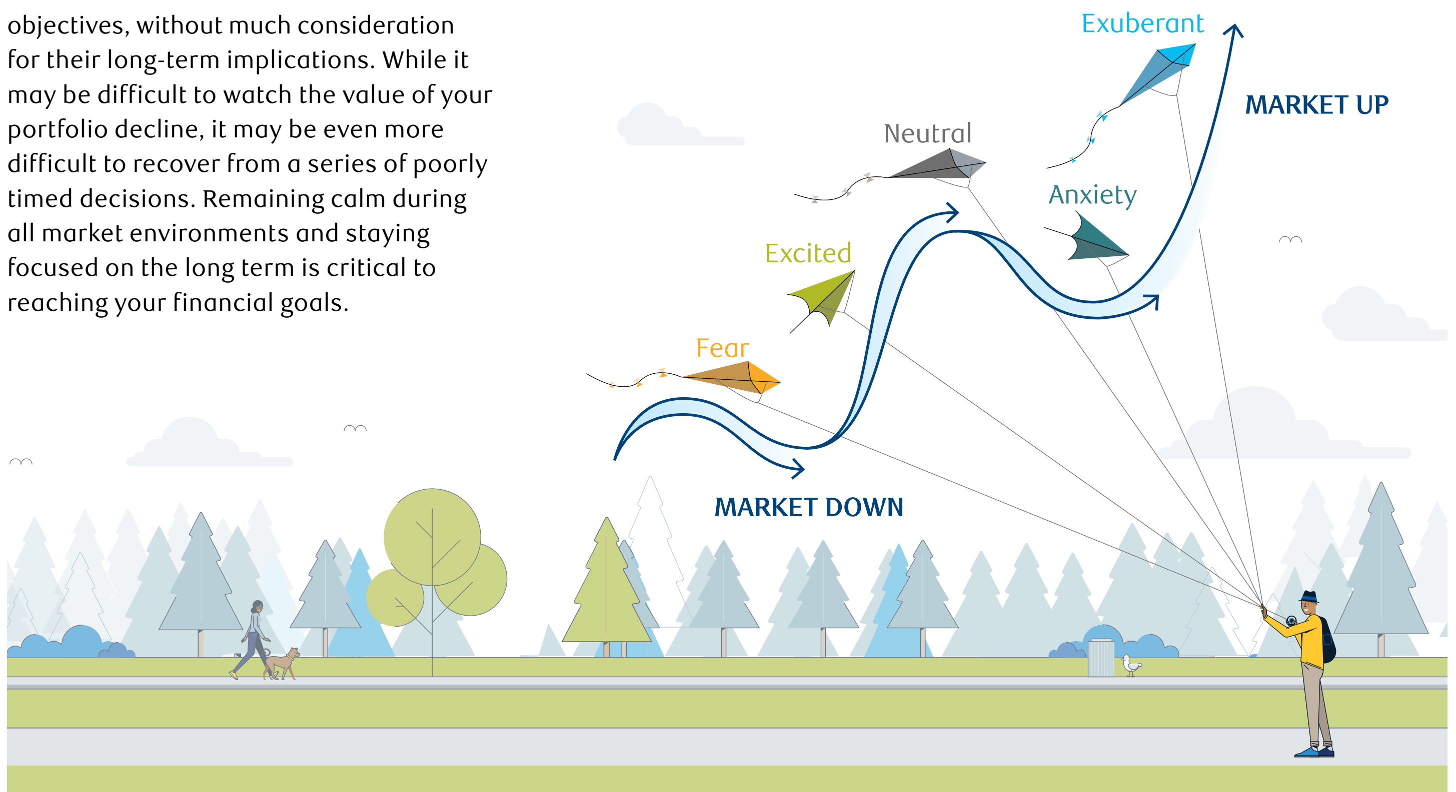
Emotional investing

How emotions can get in the way of your long-term investment plan

Watching the value of your investments fluctuate can be an emotional experience. When markets are falling and your investments decrease in value, you may worry about the impact this will have on your overall financial well-being. When markets are climbing, you may become excited and over-confident, willing to take on additional risk to see your assets grow further. All of these emotions are entirely understandable, but reacting based on these emotions can be detrimental to reaching your investment goals.

During periods of heightened emotions, decisions tend to be based on short-term objectives, without much consideration for their long-term implications. While it may be difficult to watch the value of your portfolio decline, it may be even more difficult to recover from a series of poorly timed decisions. Remaining calm during all market environments and staying focused on the long term is critical to reaching your financial goals.

The ups and downs of investor emotions

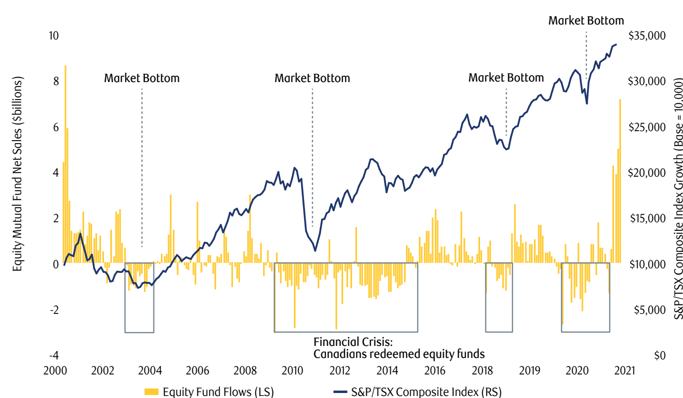


Emotions can prove costly

When shopping, most consumers prefer to look for deals on goods and aim to pay the lowest price possible. Yet, when it comes to investing, history has shown that investors tend to purchase at higher prices as markets advance and do not take the opportunity when markets are declining to pay lower prices. The chart to the right shows a positive relationship between equity mutual fund sales and equity market performance. As equity markets were soaring during the tech bubble of 1999/2000, so were equity fund sales. And following the financial crisis of 2008/09 and during the early days of the COVID-19 pandemic when equity markets tumbled, Canadians redeemed their equity funds. The problem is that investors are consistently buying high and selling low, a situation that can lead to disappointing portfolio performance over the long term.

A study by DALBAR, a leading financial services market research firm, found that the average annual return for an equity mutual fund investor over the 20-year period ending December 2020 was 5.96%. This compares to the S&P 500 Index, which returned 7.47% per year over the same period. The study concluded that underperformance was mostly explained by investor behaviour during periods of market stress, resulting in poor timing decisions. After 20 years, this underperformance would have resulted in a difference of over $100,000 on an initial investment of $100,000.[1]

Relationship between equity mutual fund sales and equity market performance



Source: RBC GAM, IFIC, Bloomberg. As of February 28, 2021.

Investor behaviour results in poor timing decisions

	Annual Return[2]	Jan. 2001	Dec. 2020
S&P 500	7.47%	$100,000	$422,420
Average equity investor	5.96%	$100,000	$318,302

Controlling your emotions

Remaining calm during all market environments and staying focused is critical to reaching your goals. Here are a few suggestions:

1 **Ask big picture questions**

There are reasons why you began investing in the first place, which in turn helped determine how your portfolio is constructed. It may be helpful to revisit these goals when volatility picks up to see if anything has changed.

If you've answered "yes" to any of the questions to the right, then ask yourself why you need to make any changes, particularly knowing the risks involved in getting it wrong. If the only thing that has changed is the short-term value of your portfolio, should this affect your long-term plan? However, if the answer to any of the questions is "no," discuss these changes with your advisor as they will review and work with you to adjust your investment plan. These bigger picture questions can help shift the focus away from the short-term discomfort.

Consider asking yourself questions like:

- Are my goals the same now that my investments have declined?
- Is my investment time horizon the same as it was when we built my portfolio?
- Is my financial situation the same?
- Is my portfolio aligned with my risk tolerance?
- Does my portfolio have an appropriate level of diversification?

[1]Source: "Quantitative Analysis of Investor Behavior, 2021," DALBAR, Inc. Returns compounded annually, ignores taxes.
[2]Returns are for the period ending December 31, 2020. Average equity investor = Average large-cap U.S. equity mutual fund investor. Average equity investor, average bond investor and average asset allocation investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: Total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions and exchanges for each period.

2 Tune out the headlines

A major source of uncertainty comes from the media, where the focus tends to be negative and sometimes alarmist. It is extremely difficult for forecasters to accurately predict where markets will go in the short term and no forecaster has insight into your unique situation. It is understandable that constantly reading alarmist headlines and negative news articles can heighten your anxiety but it is important not to base investment decisions purely on those headlines. This will only serve to heighten your anxiety during difficult times and increase the chance that you'll react emotionally.

3 Stop constantly checking your investments

Are you guilty of obsessively checking your portfolio on a daily basis? One way to reduce the emotional impact of market volatility is simply looking at it less often. The market tends to be more volatile over shorter time periods, so the more often you check, the greater the likelihood you'll see wider fluctuations in the value of your portfolio. Checking your portfolio monthly, quarterly or even yearly means you're more likely to see trends over the long term.

4 Speak with an advisor

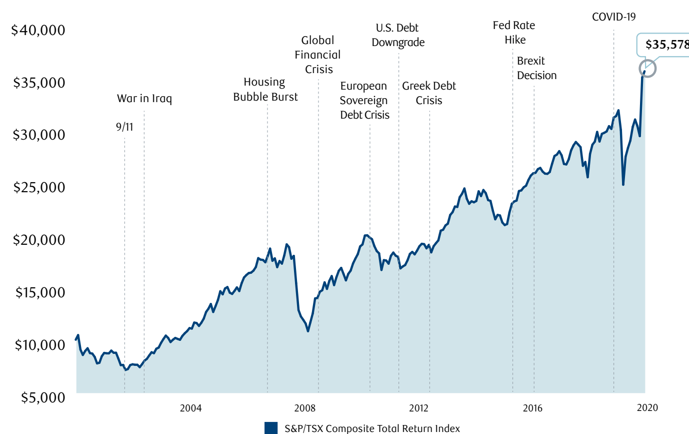
Many advisors have been through multiple market cycles and have seen difficult periods before. Having an objective advisor who can share their expertise and experience to provide you with advice during difficult times can be extremely important in keeping your plan on track.

Thinking about taking a break?

If you are nervous about market volatility and are thinking about moving your investments to cash, it is important to understand that doing so will introduce several new risks to your portfolio. While moving to cash may feel safe, remaining in cash for an extended period of time ultimately erodes your purchasing power. Even at a modest inflation rate of 2%, you will lose 10% of your purchasing power over a five-year period. Inflation is a serious threat to your long-term plan, but it's less obvious because the face value of your assets don't decline.

There will always be reasons not to invest

Markets have their ups and downs, but long-term returns are a good reason to stay invested.



For illustrative purposes only.
The growth of $10,000 since January 2001. An investment cannot be made directly in an index. Graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results. Performance data as of December 31, 2020.
Source: RBC Global Asset Management Inc.

Here are some questions to consider if you are thinking about moving to the sidelines:

- What is my plan for getting back into the markets?
- What are the tax implications of my decision?
- Where should I direct my savings in the meantime?
- How long can I afford to be out of the market while ensuring my goals are still achievable?
- When will I know it is safe to get back in?
- How can I ensure that I do not continue to pull out of the markets in the future?

Dos and don'ts for controlling emotions

- ✓ DO
  seek advice
- ✓ DO
  understand your goals, objectives, risk tolerance and time horizon
- ✓ DO
  get the facts about your investments
- ✓ DO
  stay focused on your plan.

- ✗ DON'T
  panic and act before understanding the implications of your decisions
- ✗ DON'T
  get advice from the media
- ✗ DON'T
  check your investments too frequently

Keep your emotions in check

Reacting emotionally often complicates the investment process and the more you try to time the markets, the worse off you are likely to be. Investment plans shouldn't be derailed by uncertainty and periods of volatility. Make sure to sit down with an advisor on a regular basis to review your risk tolerance, time horizon and objectives to ensure your plan is appropriate so that you can remain on track.

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