The Emotions of Investing

Emotions may help you reach your investment goals if you recognize and harness them.

BY JACK EL-HAI

In the world of investing, human emotions tend to get a bad rap. When they run amok, they can lead to lost fortunes, missed opportunities, and price run-ups. Emotions justifiably deserve some of their bad reputation, but it’s futile and unwise to try to remove them from the decision-making process. “All decisions, good and bad, are made with some emotional input,” says Richard Peterson, M.D., a psychiatrist and author of Inside the Investor’s Brain and co-author of MarketPsych: How to Manage Fear and Build Your Investor Identity. “The trick is to identify when emotions are becoming excessive.” His research has found that an overabundance of emotional thinking is behind about two-thirds of the cognitive changes that occur when investors make decisions under stress.

EXCITEMENT AND FEAR

The most overwhelming emotions at play in investment decisions, Peterson believes, are excitement and fear. Excitement builds from the possibility of gaining from an opportunity, and fear results from an extreme aversion to risk. “When they become excited, some people switch off their ability to see danger,” Peterson says. “Fear causes some people to catastrophize. When something bad happens, for instance if stock prices start dropping, their minds project prices going down to zero and they forget about economic fundamentals, which ends up leading them to panic and selling at the bottom of the market.”

These are emotional extremes that Peterson differentiates from normal and valuable emotional signals, such as the strong interest in taking profits some investors felt at the pre-recession stock market peak in 2006-2007. “They wanted to sell their stocks then, which proved to be a good decision,” Peterson observes. “That’s not the same as feeling panicked and convinced that the sky is falling and the economy is going down to nothing.”

Emotional extremes usually arise in investors when their expectations are at odds with actual returns. They feel the sudden need to react, although a wiser course may be to adapt. Peterson, who counsels financial advisors on working with the emotions of their clients, recommends that investors in these situations take a deep breath and recall how they have made successful financial decisions in the past. If they based previous decisions on an analysis of economic fundamentals, for example, they should return to that kind of reasoning. “But if they’re driven by the anxiety that comes from the fear of being left behind, they’ll likely see poorer results,” Peterson says.

HARNESSING EMOTION

Understanding one’s emotional reactions, especially an awareness of what gives us comfort and discomfort, can also be an invaluable guide to making sound financial decisions. Julie Murphy Casserly, author of The Emotion Behind Money: Building Wealth from the Inside Out, maintains that investors need self-knowledge of their “emotional numbers” as much as the financial numbers that most people consider. When she examines people’s financial decisions, she often observes what she calls “an emotional and financial disconnect.” Fifty-five-year-old homeowners, for instance, may decide to refinance a 30-year-mortgage when the last thing they may want is to continue making mortgage payments into their eighties. Stress and emotional dissonance occur when people don’t acknowledge the effects of their financial decisions after the fact. “Strategic investing should not be about making the absolute highest rate of return or keeping up with the Joneses,” Casserly says. “It should be about maximizing your return while keeping your emotional needs in balance.”

How do you achieve that? “The first step is to be honest with yourself,” she says. “You have to honor yourself. When you make an investment that doesn’t support your emotional needs, it produces consequences. If you’re investing for an endowment like Harvard’s that will exist in perpetuity, then it can be all about numbers. But we have goals and end dates—things like selling a business or contributing to a grandchild’s education—and it can’t be about getting the highest possible returns. Our emotional needs get in the way.”
The ultimate goal, Casserly believes, is to invest in a way that minimizes emotional turbulence. The worst outcomes occur when investors who have downplayed emotional needs can’t do what they want when they want. Because of the way they’ve handled their finances, for example, they must hold onto a home that no longer fits. “They’ve been chasing the wrong numbers,” Casserly says.

Our emotions demand attention. Investors may benefit from better understanding of when to listen to their emotions and when to rein them in.