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Put some distance between you and your investments

Michael Nairne, Serious Money

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Many investors' account statements are now awash in a sea of red ink as a global bear market has mauled stocks. Some investors are fleeing equities; those who are staying put may feel like someone in stalled car on a railway track with the sound of a train whistle drawing closer.

In distressing times like today, abandoning equities in a pell-mell dash for safety can wreak havoc on a sound investment plan. Since stocks typically recover well in advance of the economy, and often when the news is still dismal, the opportunity cost of shifting completely out of stocks and then attempting to time back into the market is prohibitive. With fear in the driver's seat, it is also easy to forget that the march of time is inevitable and that the demands of long-term retirement funding typically cannot be met with cash and bonds yielding 1% to 3%.

In this environment, your emotions are your adversary. Behavioural finance experts have discovered that most investors suffer from myopic loss aversion — the pain they experience from losses is much more emotionally intense than the pleasure they derive from corresponding gains; this leads to short-sighted investment decision-making. It is myopic loss aversion that fuels the frantic flight from stocks. Investors need to stay level-headed through a five-point plan to keep it at bay.

First, quit checking your investment accounts online every day. You are more likely to flee equities when you are constantly immersed in the turbulence of the market. In one behavioural finance experiment, subjects were shown the performance results of both a stock and a bond fund in a simulated portfolio and then asked to allocate between the funds. The more frequently they were shown results, the higher the proportion they allocated to the less volatile bond fund. In the end, participants who reviewed their portfolios the most frequently ended up in the most risk-averse asset mix and hence, earned the lowest returns over time.

Second, quit comparing the value of your portfolio now with its value when the stock market peaked earlier this year. Investors frequently exhibit what is called narrow framing — the inclination to view facts in a narrow context. By focusing on the most recent period of poorest possible performance, you are exacerbating your own distress. Markets are cyclical. If you want to make comparisons, also compare today's value against cyclical trough values, such as March 2009 or September 2002.

Third, quit mentally dichotomizing your portfolio into "winners" and "losers." Behavioural finance experts call this mental accounting — the tendency to categorize and evaluate economic outcomes in isolated groupings rather than as part of the whole. By fixating miserably on your stock losses while glorifying your bond gains, you inevitably end up promoting "sell low and buy high" behaviour. The whole point of diversification is to invest in a combination of ever-changing "winners" and "losers" so that your total portfolio achieves long-term positive returns with acceptable volatility.

Fourth, revisit your long-term investment plan. Your plan should have been built with an asset allocation appropriate to your ability and willingness to take risk. Recall that at a less nerve-racking time, you were quite comfortable with the trade-off between short-term portfolio volatility and long-term return potential.

Finally, tune out the media noise. Most of it is designed to arouse emotion, not provoke contemplation. It also focuses on the state of the world today and in the next year or so, not 10 years from now — which is what matters for long-term growth assets.

Pogo, the cartoon character, said, "We have met the enemy and he is us." Indeed, in turbulent markets, your own worst enemy can be yourself.

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