How do you behave in the face of fear?

By Tom Stevenson, 18 February 2010

Understanding how to read your emotions might be the most valuable investment lesson you learn.

How do you behave in the face of fear? Do you run towards danger, or turn and flee? Knowing how you and others react to extreme situations might seem remote from the world of investment, but could have a lot to do with what separates the great investors from the rest of us.

"Humans have a tendency to be more scared of the things they cannot control." Tom Stevenson

Humans have a tendency to be more scared of the things they cannot control. For example, you are statistically much more likely to die in a road accident in the UK than you are in a plane crash anywhere in the world. But it is most unlikely that you feel the same apprehension pulling away from the kerb as you do when your flight gathers pace on the runway.

In the same way, we fear losing our money in an uncontrolled market crash even though this is actually rather less likely than losing it through poor decisions or even simply inertia.

Before anyone makes an investment, they should consider what type of investor they are, how they cope with their emotions and what kind of appetite they have for risk. The conventional approach to doing this is often a box-ticking exercise which asks anodyne questions like; "are you prepared to take a little more risk for the possibility of a little more return?"

What a basic box-ticking exercise fails to take account of is the messy humanity of investors. We are all prone to changing our minds, inconsistency and a general propensity to react more to emotions than rational analysis when making investment decisions.

The influence of these hard-to-control, hard-wired human instincts on our investment decisions is a central concern of the new science of behavioural finance and it is discussed in several books on the psychology of investing. One of my favourites is Your Money and Your Brain by Jason Zweig.

Novice investors need to understand that there are different types of risk and that not all of them are bad. In many people's minds, risk is now associated with the reckless behaviour caricatured by the fallen Masters of the Universe on Wall Street and in the City. We tend to assume that vivid disasters, like the recent financial crisis, are rather more likely than mundane slow-motion catastrophes like the value of our investments being eroded over time by inflation. They are not.

An inexperienced or apprehensive investor should overcome this aversion to risk and be prepared to embrace the risks they can control. They should understand that being too cautious with their investments is a risk in itself and could mean they fail to achieve their financial goals. Investing money in what are perceived to be riskier assets might actually be safer than putting it in the bank.

To make matters worse, humans are inconsistent in their inconsistency. This can make it near impossible to

pigeon-hole investors into neat high, medium and low-risk categories. Most people would immediately recognise themselves as a glass-half-empty, or glass-half-full type of person. But consider this study. One group of people is shown an empty glass which is then half filled. The majority describe the glass as half full. Another random group of people is shown a full glass from which half the contents are subsequently poured. The majority of these people describe the glass as half empty.

The way a question is phrased and the context in which it is asked clearly influences our perception of it and therefore our response. On tackling your first profiling questionnaire, you might feel apprehensive and therefore more cautious, or perhaps more bold than usual. This could influence your responses to the risk-profiling questions you are asked.

The same instinct that made early man run from a sabre-toothed tiger tens of thousands of years ago, gives professional investors sweaty palms today. What else explains the instant market reaction whenever a company reports disappointing results, or when a negative rumour circulates the City? How can these well-trained, highly-professional investors suddenly panic and sell a carefully-researched investment that moments before they believed in implicitly?

It is clear that we cannot reverse tens of thousands of year of evolution so it is better to understand the power of these instincts and take account of them at those crucial moments when decisions are made. Better still, investors can leave the decisions to others by saving regularly rather than trying to time investments according to market conditions and by choosing managed investments rather than going it alone.

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