

Why you'd be nuts to abandon a long-term investment plan

HAVE you ever put an alarm clock on the other side of your bedroom to stop yourself hitting the snooze button in the morning? Or moved a bowl of nuts out of arm's-reach at a dinner party to stop yourself from nibbling your appetite away?

When studying economics, I was taught it does not make sense to place nuts out of arm's-reach. If I did not want them, I would not eat them, so why go to the trouble of removing the bowl?

Equally, a decision to press the snooze button on the alarm clock reveals a preference for a few more minutes' shut-eye. If your preference is to wake up, why place the alarm clock out of reach?

According to author and prominent behavioural economist Richard Thaler, the distinction between what we want and what we choose has no meaning in traditional economic theory. Problems with self-control have no place in the rationalist theory of economics.

To borrow a phrase from Yogi Berra, an American baseball star known for his malapropisms: "In theory there is no difference between theory and practice; in practice there is."

In real life, the decisions we make are not rooted in rational economic theory. This has wide implications for many facets of our lives, none more so than in matters relating to finance. Take the glib assumption of rational decision-making that my own industry – investment – has borrowed from the theorists. As a result

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we have been effectively washing our hands of arguably the most important aspect of what it means to invest successfully: getting investors to stay the course through the inevitable ups and downs along the journey.

In the main, investors do not like volatility and are averse in the extreme to multiple periods of negative returns (which occur with far more frequency than finance theory predicts).

Investors require some emotional comfort along the way. Emotion, however, is to be controlled and not pandered to, according to the theorists.

By betting against the obvious and powerful force of human fallibility, the traditional approach to investing is setting investors up for expensive failure.

A more sensible approach is a behaviourist one, which embraces our own emotional fallibility, and plans for it.

To have any practical hope of achieving long-term financial objectives, investors need to follow a simple – though possibly not easy – set of rules:

Rule 1: Use a financial adviser or someone not emotionally connected to the investment. Despite best intentions, people get derailed from



their investment plans and are tempted to chase the illusive next best thing. Investment returns will not be determined by investment performance so much as by your investment behaviour, and this can be influenced positively by impartial advice. In the spirit of full disclosure, while I do not provide financial advice directly to clients, I do work with financial advisers.

Rule 2: Sign up to a plan that is drafted in a period of calm. A fear of regret that the investment will perform badly or a focus on the possibility of future losses might make the investor reluctant to seek good investment advice in the first place.

The emotional insurance in taking less risk than is appropriate given long-term risk tolerance and risk capacity. This reduces long-term returns, sometimes dramatically.

A balanced risk investor who remains in cash may be paying a 4%-5% opportunity cost premium for reduced anxiety. This is unnecessary. Draft a plan during a tranquil period and commit to it.

A good adviser will act as your emotional coach and provide what you need, which

may sometimes conflict with what you want.

Rule 3: Don't over-monitor your portfolio. It's a well-documented phenomenon that the more frequently an investor observes the performance of his/her portfolio, the more inclined they are to make changes. Activity is your enemy. The cheapest form of anxiety reduction is to stop looking at your portfolio as frequently. There may be practical limits to how far this can be pushed, but your adviser is there to monitor things for you. Though you may receive quarterly valuations, you certainly don't need them.

Rule 4: Finally, meticulously avoid business television channels or emotionally charged media articles – Downton Abbey or the sports section are fine. We only have a certain well of emotional comfort to draw from and it gets depleted, so save it for important stuff.

The battle against innate biases and self-control issues is a struggle without a finish line, so these rules should be kept under constant review. Some people need a little more emotional comfort than others, but no one needs to pay a large percentage premium of their wealth per year to get a little rest. So start with rule number 1 and work from there.

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