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UNDERSTANDING THE PSYCHOLOGY BEHIND INVESTMENTS

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Abstract:

Investing all our savings in hope to earn more can be a very courageous decision to make. There are a variety of factors which play a vital role in make any decision regarding investing. Out of all the factors which motivate an individual to put their money in any investment account, it has been observed that having a 'good instinct' is the most influential one. Human mind is a very powerful tool and our sub-conscious mind often makes the decision for us without us realizing it. We are guided by our experiences and emotions. This is particularly true in making financial decisions. This paper explains the correlation between human psychology and investment decision modeling. It explains the common psychological traps which a person can fall on and thus make bad investment decisions. It also lists recommendations to prevent ourselves from being a victim of our own emotions and psyche when it comes financial decisions.

1. Introduction

An investment is an asset or item acquired with the goal of generating income or appreciation. The decision of investing your life-long savings in the present or future of a third party can be very daunting one to make. It takes a lot of courage, well-structured thought process,

knowledge of markets and most importantly 'good instinct' to make any investment decision. A 'good instinct' is more than often the deal breaker. An individual may have all the knowledge and understanding of the finances, but he/she counts upon his/her 'feeling' about the investment to make the final decision. Understanding the factors which influence this 'feeling' and 'instinct' can play phenomenal role in learning to make good investments. These biases of judgment and decision-making are called cognitive-illusions.

2. The Fundamentals of Investing

In an economic sense, an investment is the purchase of goods that are not consumed today but are used in the future to create wealth. In the world of finance, an investment is a monetary asset purchased with the idea that the asset will provide income in the future or will later be sold at a higher price for a profit.

The term "investment" can refer to any mechanism used for generating future income. In the financial sense, this includes the purchase of bonds, stocks or real estate property. Additionally, a constructed building or other facility used to produce goods can be seen as an investment. It is often misunderstood that investment is only related to 'share-markets'. In true sense, if a person decides to use his/her money in hope of earning more money out of it, he/she is investing. For example, when choosing to pursue additional education, the goal is often to increase knowledge and improve skills in the hopes of ultimately producing more income. So, in a way the money you pay as tuition to attain higher education is also an investment.

Some common type of ownership, lending and other investments are enumerated below:

- Stocks: Also known as an equity or a share, a stock gives you a stake in a company and its profits. Basically, you get partial ownership of a public company.
- Bonds: "Bond" is a more umbrella term for any type of debt investment. When you buy a bond, you loan money to an entity (a corporation or the government, for example) and they pay you back over a set period of time with a fixed interest rate.
- Venture Capital: This is money you give to a startup or small business, with the expectation that it will grow, and you'll get a return on that money. A lot of times, venture capitalists become partners in the company, owning part of a its equity and getting a say in business decisions.
- Index Funds: A type of mutual fund meant to mirror the return of a specific market, like the S&P 500.
- Exchange Traded Funds (ETFs): These are very similar to index funds in that they're meant to track an index, or a measure of a specific market. The biggest difference is the way they're traded. ETFs can be traded like stocks, and their prices adjust like stocks throughout the day. Mutual and index funds don't work this way.

3. Psychological Traps of Investing

Hope and opportunity to gain are the two things which can propel any individual to take risk. This is particularly true for people who make decisions regarding investments. They are willing to put their life-time earning at risk hoping to earn more out of it. It is natural that the thought processes often lead then to fall into traps which cause them financial loss. In order to solve a problem, it is necessary to identify it first. Thus, it is important to understand the common psychological traps which can lead anyone into a bad investment decision. Most common such traps are explained below:

- Anchoring Trap: This results from one of the most common personality issue: Over-confidence. When we are 'anchored' to what we believe to be correct, it almost impossible to think from a broader perspective or realize our

mistakes. For instance, if you think of a certain company as successful, you may be too confident that its stocks are a good bet. This preconception may be totally incorrect in the prevailing situation or at some point in the future.

- Sunk Cost Trap: This one results from psychologically protecting your previous choices or decisions — which is often disastrous for your investments. It is truly hard to take a loss and/or accept that you made the wrong choices or allowed someone else to make them for you. But if your investment is no good, or sinking fast, the sooner you get out of it and into something more promising, the better. Being emotionally attached to your decision can be detrimental not only for investments but also in personal life.
- Confirmation Trap: In this trap people often seek out others who have made, and are still making, the same mistake. Make sure you get objective advice from fresh sources, rather than consulting the person who gave you the bad advice in the first place. Even if you get all the advice, the final decision to make or not to make the investment should always ne yours.
- Blindness Trap: Situational blindness can exacerbate the situation. Even people who are not specifically seeking confirmation often just shut out the prevailing market realties in order to do nothing and postpone the evil day when the losses just have to be confronted. It takes courage to accept the reality and one must be emotionally strong to be able to do that.
- Relativity Trap: The relativity trap is also there waiting to lead you astray. Everyone has a different psychological make-up, combined with a unique set of circumstances extending to work, family, career prospects and likely inheritances. This means that although you need to be aware of what others are doing and saying, their situation and views are not necessarily relevant outside their own context. Be aware, but beware too! You must invest for yourself and only in your own context.
- Irrational Exuberance Trap: When investors start believing that the past equals the future, they are acting as if there is no uncertainty in the market. Unfortunately, uncertainty never vanishes. There will always be ups and downs, overheated stocks, mini-bubbles, industry wide losses, panic selling and other unexpected events in the market. Believing that the past predicts the future is a sign of overconfidence. When enough investors are overconfident, we have the conditions of Greenspan's famous, "irrational exuberance," where investor overconfidence pumps the market up to the point where a huge correction is inevitable. The investors who get hit the hardest are the ones who are most overconfident.
- Pseudo-Certainty Trap: This phrase is an observation about investors' perceptions of risk. Investors will limit their risk exposure if they think their portfolio/investing returns will be positive – essentially protecting the lead – but they will seek more and more risk if it looks like they are heading for a loss. It is a game of all-in or all-out. This perception of risk can force investors to make wrong decisions which eventually results in loss.

From above, it can be said that human psychology can be a dangerous thing, and there are some alarmingly standard mistakes that people make again and again. It is very easy in the heat of the moment, or when subject to stress or temptation, to fall into one of these mind traps. The wrong perceptions, self-delusion, frantically trying to avoid realizing losses, desperately seeking the comfort of other victims, shutting out reality and more can all cost you dearly.

4. Recommendations to Avoid Bad Investing Decisions

In order to avoid the pitfalls of bad investments, it is important to gain an understanding of and learn to control your own psyche. Be aware of the traps mentioned above

and always be honest and realistic with yourself. Our mind is very powerful. It can deceive us when we think that we are befooling it. The power of sub-conscious mind should never be ignored. More than likely we know the mistake we are about to make yet we convince ourselves to make it anyway. Understanding and accepting this fact can help us in locating the root cause of our bad decisions which will often be linked to our emotions. Some remedial methods for these cognitive-illusions are listed below.

1. Keep track of instances of your own over-confidence. This can help in self-analyzing your behavior and thus combating the tendency to make bad decisions.

2. Resist the urge to be over-optimistic about situations and solutions. Think of the things which could go wrong before over-committing just because you 'feel' that it will all be alright.

3. Communicate realistic odds of success to clients. This is also true in personal space. Always be realistic.

4. Ask yourself if you have real reasons to believe if you know more than the market. This will help you prepare better for any situation and also prevent any trap of overconfidence.

5. Before making any decision, discuss the conditions and underlying assumptions beforehand. Some things are assumed implicitly but it is always good to be explicit when making critical decisions.

6. Remain flexible in your thinking and open to new sources of information, while understanding the reality as well.

7. Never compare your situation with others even if they appear the same. Comparisons often result in a vast variety of negative emotions like jealousy, anxiety and insecurity. These can adversely affect your psychological well-being and prevent you from being your best.

8. Learn when to let go. Do not let your emotions invest for you.

Good investing skills comes from years of experience and learning from past mistakes. There is no shortcut to success. However, if one tries to practice above steps, they will become more aware of sub-conscious shortcomings, be able to observe their own psyche and thus be able to succeed in making the right choice.

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