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OPINION

The five deadly sins investors should avoid

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Financial advisors play a big part in helping investors spot and manage the behaviours that could lead them to make big mistakes with their investments.

Warren Buffett once said that "the most important quality for an investor is temperament, not intellect." That has never been truer given the fast-paced world in which we live. The challenge is that a good temperament is not something most investors have learned or developed.

To do so, investors must become aware of the mistakes they are prone to make. Those usually stem from behaviours and habits that all human beings are subject to; the five deadly sins listed below are ones that investors should avoid at all costs.

Financial advisors play a key role in that process. They are there to coach their clients on spotting and managing these behaviours, which most investors don't even know they exhibit.

Greed

This is a big one. Some of the most irrational behaviours we have seen in finance often come from greed. In the world of investing, it's most evident when investors hang on to a winning position for too long in order to get the maximum value out of it.

For example, let's say a model portfolio has a 20 per cent exposure to the technology sector, which generates very strong returns for many months in a row. Instead of rebalancing the portfolio when the sector outperforms, an investor's greed lets it go higher and higher until it reaches 40 per cent of the portfolio.

That happens because the dopamine hits an investor's brain keeps getting from those stocks' strong performance encourages the person to take on a lot more risk than they were supposed to. That's what greed does.

For advisors, helping investors follow a defined investing process devoid of any emotion is the only way they can be protected from letting greed get the best of them.

Jealousy

Being envious of somebody else's returns is likely the behaviour that affects people the most. The classic case can be described as follows: An investor goes to a family reunion at which his brother-in-law talks about the amazing returns he is making on a specific stock and how good he is at managing his portfolio. That investor then calls his advisor afterward and asks to invest some of his money into that same stock.

There are a couple of key considerations from that example. First, did the investor determine if his brother-in-law has the same risk tolerance or goals that he does? Second, did the investor ask his brother-in-law about the times he failed or lost money on a stock? Chances are that the people who brag about their strong performance never talk about the times they lost money on a stock.

For investors, jealousy is a sign they're not confident in their plans and will allow emotions to dictate what to do in their portfolios. Advisors need to be on the lookout for this behaviour.

Laziness

Yes, being lazy is a thing in investing. Specifically, that happens when investors continuously put off doing important tasks. They'll say things to their advisors such as, "I'll invest when I'm ready," "I will make my contribution next year," or "I'll give you the information for my financial plan later." It's very easy for people to put off things that they're supposed to do when it comes to money.

A good way advisors can help is by acting like a personal trainer to their clients. Namely, advisors can give their clients specific tasks and demand accountability. The best advisors understand that managing investors is as important as managing investments – and having to hold investors' hands sometimes is a big part of the job.

Revenge

This behaviour is not generally one that someone thinks about as it relates to investing. Yet, it does tend to come up.

For example, let's say an investor takes a position in a stock, which then drops heavily just a few weeks later. Although all investors will be disappointed by that turn of events, some will take it to the next level by getting mad at the stock market because they think it "owes them" returns.

These investors will often want to double down on their lost position to try to make their money back and will tend to blame the market for their own faulty decisions.

The reality is that the stock market does not give you high returns just because you need them or want them. Advisors need to be able to say no to their clients when they get carried away.

Recency bias

This behaviour is the most difficult to detect. It's described as the tendency to place too much importance on experiences that are the freshest in our minds. For investors, it usually means that whatever just happened in the markets will be what they expect will be more likely to happen in the future.

Younger investors are more subject to recency bias because they tend to interpret the good fortune they just had with investing as a validation that they are "right" and that they will continue to be correct if they keep doing the same thing. Sadly, the only way they'll learn is by suffering a significant loss through a sudden change in the market.

Advisors can get ahead of that by educating investors to understand that what worked in the past might not be what will work in the future.

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