Chris Horan, Financial Advisor

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Investor Psychology

Chris Horan, CFP, RFP
Senior Financial Advisor
Assante Capital Management Ltd.
1100-320 Bay St. Toronto, Ontario
M5H 4A6

Telephone: (416) 216-6500
Toll Free: (800) 565-4605
Email: choran@assante.com

Article Background

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Yahoo! Update

Readers of my newsletter essays know that I've been skeptical of the investment merits of many of the technology stocks.

We, as I write this, in less than four weeks the NASDAQ index lost 34% of its value – a loss of more than US$3 trillion, or about ¼ of the US GDP.

Yahoo!, the net portal stock, has fared relatively well, having fallen by half from its high in January.

A number of years ago I sat at dinner beside the head of a very well known Bay Street firm, and I asked him what he thought was the secret of successful investing. I will never forget his answer: " Well, Chris, this business is all about fear and greed. Once you understand that, it becomes a lot easier." This essay is the first in a series on the most important aspect of investing: psychology.

There have been many studies over the years of the patterns of investor behaviour. Probably the best known was conducted by Morningstar, a U.S. investment research firm whose analysis showed that despite a five-year average annual return of 12.5% for a group of 219 growth funds, the average annual return of individual investors in those same funds was –2.5%. That's right. The average investor dollar invested in those funds actually lost money.

How? Because all investment managers, even those with great long-term records, experience frequent temporary declines in value. And investors tend to move assets into funds that have gone up recently and move out of funds that have poor short-term performance. Buy high, sell low.

A specific example? The Ivy Canadian Fund at the end of 1998 was a solid above-average performer, sporting a five-year return of over 14% and a top four-star Globe rating. The fund had grown to $5.9 billion in assets in only 6 years since its inception in 1992. The fund was entirely invested in value stocks, and held no technology stocks.

Little more than a year later, by March of 2000, stung by the spectacular technology craze, almost $1.7 billion or 27% of assets had fled the fund.

Where did the money go? Technology stocks, mostly. According to Barron's, a financial paper, eight out of ten dollars went into tech stocks or tech funds in 1999. The Universal Future Fund, a tech-oriented portfolio, experienced a sizzling 1999 return of 70%. Almost $700 million of new money flowed into the fund, doubling its size over only eight months up until May 2000. That's right. The last $600 million was transferred into the Future Fund after the stellar 1999 performance, precisely in time for the 50% correction in the tech market. A stunning example of "sell low, buy high."

My advice? Understand that putting your money into whatever has gone up the most in the last chunk of time is always the most tempting but also the most dangerous thing you can do. Understand that unpopular investment classes (like companies that have customers and profits) eventually regain their favour. Understand that all great money managers have periods of cool performance. Understand why the world's most successful investors all say the same thing: Have a plan tailored to you, invest with wise managers, and have the discipline to be patient.

Successful investing is about time, not timing.