Understanding Volatility: Your emotions matter!

Turbulent times in financial markets will predictably stimulate powerful non-rational behaviours amongst even the most seasoned investors. Traditional finance theories assume we are all perfectly rational and always make choices to maximise returns. However, in reality, emotions and cognitive biases significantly impact decision-making, especially during volatile market conditions.

Let’s look at a few of the cognitive biases we may recognise in ourselves!

1. Loss aversion

One classic behaviour is how we naturally distinguish between pain and pleasure. Research shows we are twice as motivated to avoid pain as we are to seek pleasure. This means we feel pain from an investment loss significantly more than we get pleasure from a gain. Even though mathematically it would make more sense to see losses and gains as similar measurements, it feels to us like they are not. This asymmetry leads to risk-averse behaviour when facing potential losses, causing us to either sell investments at the wrong time and lock in a loss, or hold investments for too long to avoid an inevitable loss.

2. Herd behaviour

Investors often follow the actions of others, particularly in times of uncertainty. This herd mentality can lead to market bubbles and crashes, as we buy or sell based on the behaviour of the crowd rather than an analysis of fundamental factors. For example, during the dot-com bubble of the late 1990s, many investors jumped into tech stocks without due diligence, leading to a dramatic market correction, with the NASDAQ Composite Index falling **78%** from its peak by October 2002.

3. Overconfidence bias

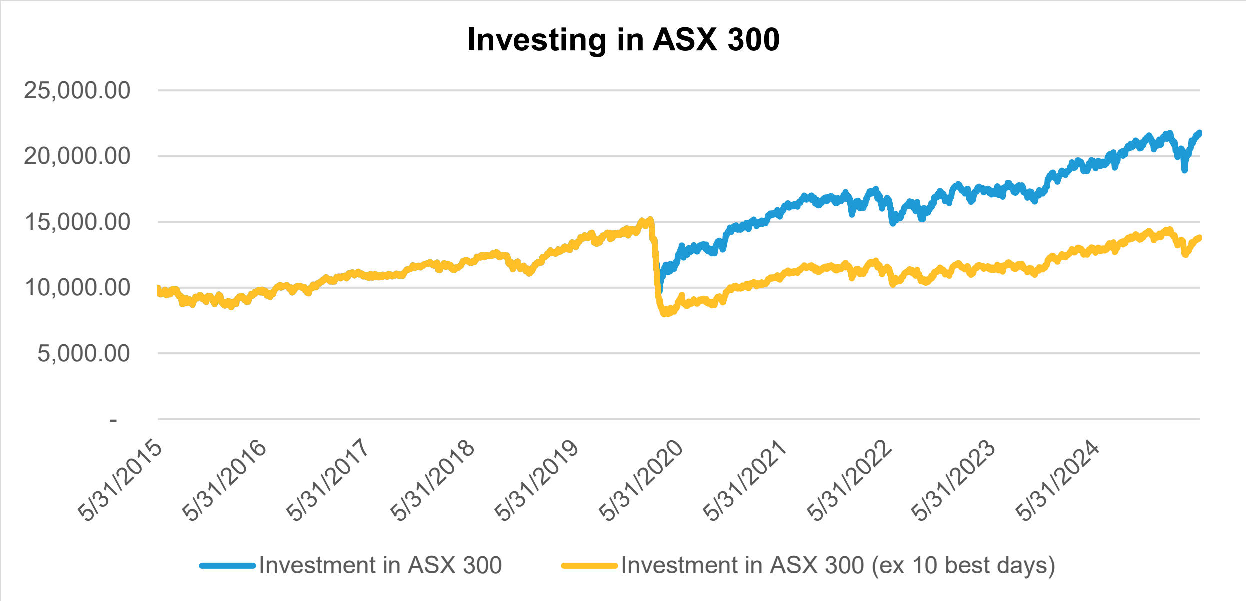
Overconfidence can lead investors to overestimate their knowledge or ability to predict market movements. This bias often results in excessive trading and failure to diversify adequately, increasing exposure to risk. For instance, traders may believe they can time the market effectively, leading to impulsive decisions based on short-term fluctuations rather than long-term strategies.

4. Fear and greed

Emotional responses such as fear and greed dictate the decisions investors make during volatile market conditions. Fear of losing money can prompt rash selloffs, while greed may lead to excessive risk-taking during market upswings. Understanding these emotions is crucial for maintaining a rational investment strategy.

As Chart 1 below shows, missing the 10 best days of the ASX 300 over the past 10 years would have resulted in a more than a $9,000 difference in return from an investment of $10,000 in 2015.

CHART 1



5. Recency bias

This bias occurs when investors give greater weight to recent events or trends when making decisions, often ignoring historical context. For example, if a stock has performed well recently, an investor might overestimate its future performance, leading to poor investment decisions during volatile periods.

6. Confirmation bias

This bias occurs when investors choose to favour information or interpretations that confirm their pre-existing views. For example, investors tend to look for information that favours their investment decision, such as a positive news article or comment, and ignore ambiguous or negative news such as contradictory data.

7. Availability bias

This bias occurs when investors rely on immediate examples that come to mind rather than evaluating all the information on a particular investment decision. For example, if a particular investment has received significant media attention, investors may overstate its likelihood of success.

8. Anchoring bias

Investors can often rely on a single piece of information when making a decision. This “anchor” reference point can disproportionately influence their judgements and decisions even if this anchor is irrelevant or arbitrary. For example, investors can look at the price of a share investment and anchor to that value regardless of evidence that the stock is worth more or less at a given time.

At AB, we are committed to handling risk. Our professional investment managers look at a range of risk metrics on a daily basis – assessing the market and individual companies to ensure a balanced approach to risk in our portfolios.

Ask your adviser for more information on AB's range of strategies that are designed to deliver strong long-term returns by reducing the impact of market volatility.