How do your personality and your feelings play a role in investing?

Imagine making your money work for you… Imagine finding a safe place where you can store your money and when you return, you find more than what you put in… Earning a positive return on any investment is the goal of every investor. But you might be surprised to find out that knowing your own personality and being aware of your emotions can play a huge role in how successful you are at investing.

How many stories have you heard of people making "lots" of money by investing in Bitcoin? While that may be true for some, it's not true for all. Firstly, the more people jump on the bandwagon, the less profit is available per person (you're dividing the same amount of profit between more people).

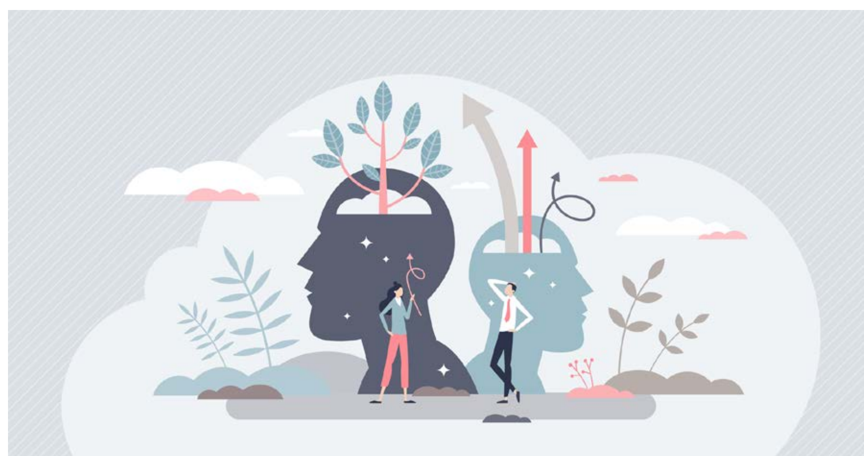
Secondly, if more people jump on the bandwagon, you're going to increase the price (more demand whilst supply stays the same means that price will increase). You then see how your "wise" decision to follow the crowd is paying off because you bought at the right time. This "confidence" is just a self-fulfilling prophecy that was bound to happen to the economic fundamentals of supply and demand.

Understanding risk and return is key not just to investment decisions but to life in general. Risk and return are the foundations of any finance course at university. Students are taught that, in theory, risk and return are positively related. In other words, if you take on more risk, you should earn a higher return. In practice, this relationship doesn't always hold for a variety of reasons. Did you know that one of those factors is your emotions and personality? Let's explore how emotions and personality can influence your investment decisions.

Homo economicus vs *Homo dramaticus*

Textbooks describe financial market participants as rational decision makers, known as *Homo economicus*. These decision-makers crunch numbers in their heads (or on the PC) and make a logical, reasonable decision to buy or sell shares in the market. However, making a rational decision is easier said than done, especially when emotions enter the equation. To take an extreme, dramatic example – if you just got married before going to work at 9am, will your emotions influence your productivity or the decisions you make that day? Or, if you just had an accident or were stuck in traffic for a really long time before arriving at work, would your bad mood influence your productivity or decisions? It's easy to see that what happens around us can influence how "rational" we are in making what seem like easy decisions.

This deviation from the textbook has emerged as a field called "behavioural finance". It focuses on how investors make decisions and uses principles from various fields such as psychology, biology and computer science in an attempt to better understand how and why investment decisions are made.



Behavioural finance has shown that investors don't always make rational decisions – we are "quasi-rational". In fact, our emotional state and personalities are indeed needed in making investment decisions.

Being aware of our emotional state when making important decisions helps us to re-think whether our chosen course of action is thought through, or needs to be paused until further notice.

Here are some common findings from behavioural finance on how emotions and personality play a role in investment decision-making:

1. Overconfidence

Your outlook on life plays a major role in whether you want to take on that investment risk. If you relate to the Bitcoin example above, by consistently "winning", you are now more optimistic, leading you to have more confidence in your investing skills and therefore wanting to take on more risk. This overconfidence eventually leads you to making a poor investment decision.

Conversely, pessimists are typically more cautious, and while they don't take on more risk, they do miss potentially lucrative opportunities, once risk has been accounted for. Be aware of which camp you fall in to ensure that this doesn't cloud your judgement.

You can avoid being overconfident by simply trading less and investing more. What does that mean? When you want to earn a return, do so by thinking about the long term. We human beings want things now – so we tend to be satisfied with what we get immediately as opposed to waiting for a greater payoff at some point in the future. If you invest, you are thinking with a longer-term horizon compared to trading (which can be just for a day or even shorter).

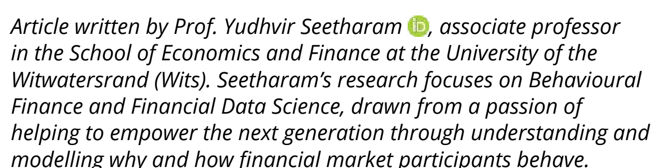
2. Patience

Do you act on instinct? Or do you like to crunch the numbers and think things through carefully? While both can certainly pay off, it's again important not to become overconfident in relying on what worked well in the past. In other words, each investment opportunity you're presented with calls for a "clean" investigation, regardless of what worked for you before. If you're patient, you might miss the chance to gain a high return; however, if you're impulsive, you might invest only to lose your money. This helps us avoid feeling regret at losing. We see from research that many traders or investors would rather not sell shares to avoid feeling the regret of having sold "too soon" or having to feel the loss of their investment. You can minimise this feeling by having trading rules which help you to decide whether to sell or not.

3. Open-mindedness

An open mind can sometimes eliminate old (bad) habits, or cultivate new ones. Being open-minded can help you diversify your portfolio by investing in various asset classes – like equity, bonds, property or even cryptocurrency; whereas being closed-minded can sometimes help you preserve (protect) what you have and avoid losses. Of course, with an open mind, we sometimes can look to the wrong sources of information to help us make a decision. If your role model bought Bitcoin, would you just blindly do the same? Knowing what to focus on to make decisions is as important as making the decision itself.

What's important from the above is that there is no simple recipe for making a good return on your investment. If there were, then every student who's ever studied finance for years at university, or every person who spent a few hours reading a book on the subject, would be a millionaire. Knowing who you are, how you react, and what emotional state you're in whilst making investment decisions all point to being alert to these kinds of biases that we all have; and then taking the necessary steps to minimise their negative impact on our investing decisions.



Article written by Prof. Yudhvir Seetharam, associate professor in the School of Economics and Finance at the University of the Witwatersrand (Wits). Seetharam's research focuses on Behavioural Finance and Financial Data Science, drawn from a passion of helping to empower the next generation through understanding and modelling why and how financial market participants behave.