Avoid self destructive behaviour

"Individuals who cannot master their emotions are ill-suited to profit from the investment process."

Benjamin Graham,[1] father of value investing

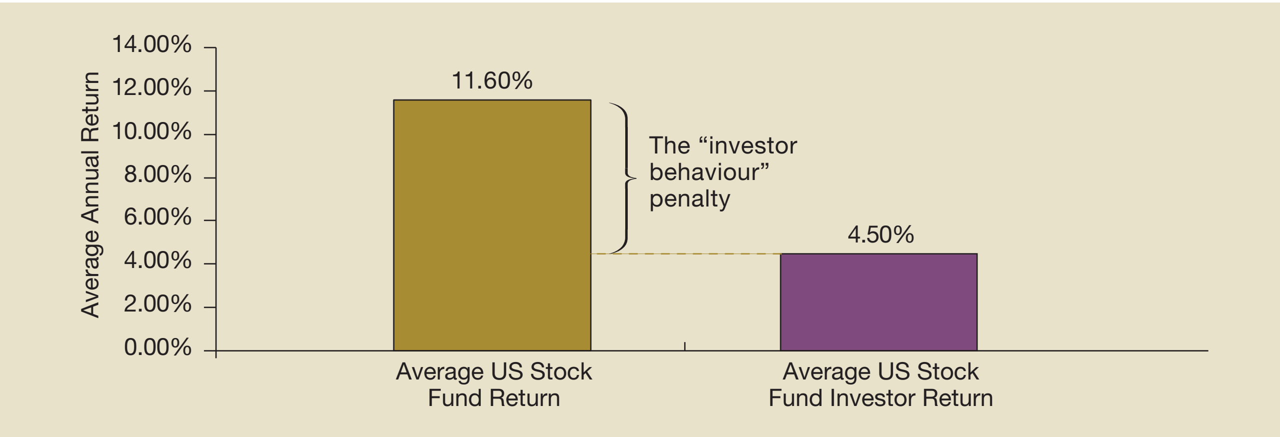
EMOTIONS can wreak havoc on an investor's ability to build long-term wealth. This is illustrated in **Chart 1**, below. Over the 20 year period from 1988 to 2007, the average US managed fund returned 11.6% p.a. If we look at the actual return the average investor received when you take into account their timing into and out of the funds, it comes as a surprise to learn that the average managed fund investor earned only 4.5% p.a. over the same period.

Question: *Why did investors miss out on nearly two-thirds of their potential return over this period?*
Answer: *They let emotions guide their investment decisions.*

Perhaps driven by powerful emotions like fear and greed, many of these US investors engaged in behaviour contrary to their long-term investment strategies and as a result missed out on nearly two-thirds of the potential return over this period. This behaviour includes chasing the "hot" manager or asset class, avoiding areas of the market that are out of favour, attempting to time the market, or otherwise abandoning investment strategies. US investors are not unique; investors in Australia and around the world can be prone to the same pitfalls.

The most successful investors understand that building long-term wealth requires the ability to control one's emotions. They tend to buy low and sell high, as opposed to the emotional investor who does just the opposite.

Chart 1: Average US Stock Fund Return versus Average US Stock Fund Investor Return (1988–2007)



Source: Quantitative Analysis of Investor Behaviour by Dalbar, Inc. (July 2008) and Lipper. Dalbar computed the "average stock fund investor" returns by using industry cash flow reports from the Investment Company Institute. The "average stock fund return" figures represent the average return for all funds listed in Lipper's U.S. Diversified Equity fund classification model. Dalbar also measured the behaviour of a "systematic investor" and "asset allocation investor". The annualised return for these investor types was 5.8% and 3.5% respectively over the time frame measured. All Dalbar returns were computed using the S&P 500® Index. Returns assume reinvestment of dividends and capital gain distributions. Past performance is not a guarantee of future results.

[1] Benjamin Graham (1894–1976) is considered to be the father of value investing, an approach he taught at Columbia Business School and later refined with David Dodd during the many editions of their famous book *Security Analysis*.