AdvisorEdge

Emotional Investing: Why A Long Term View Is Crucial

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Some employees fail to invest based on fear: they don't want to think about getting old or leaving work. Other employees see their investments in too short of terms. Their investment decisions resemble a squirrel trying to cross the road: a lot of movement and not much progress. And for some employees, like unfortunate squirrels, too much change may result in tire tracks. Employees who respond to the market by moving or trading investments with every major market movement may be engaging in "Emotional Investing." This kind of investing fails to prioritize the long-term goals of retirement planning. Helping employees to see a longer-term view on their investments can help reduce anxiety, and help them meet their retirement goals.

> *"Employees who respond to the market by moving or trading investments with every major market movement may be engaging in "Emotional Investing." This kind of investing fails to prioritize the long-term goals of retirement planning. An employee's single best tool for weathering a volatile market is time and compound interest."*

Emotional Investing also has potential costs. Emotional investing often ignores other aspects of investing such as tax implications, flexibility, cost of administration and focuses only on returns. Moving assets can ding employees with transaction fees, decreasing the amount they could be earning. Reacting less to chatter about the market (by leaving assets in place) has been shown by professors at University of California–Davis to impact returns by as much as a percentage point. In addition, focusing on moving money into high or out of low positions may cause employees to lose sight of great opportunities for growth.

Nor should employees stick their money in an account and never re-assess their plans. That kind of investing isn't un-emotional investing, instead its poor planning. Some movement or reassessment of accounts on a regular basis is necessary In fact, most investors don't rebalance (or readjust) their investments as much as they should.

Nearly 90% of investors who don't work with an advisor fail rebalance their accounts regularly. So what is the difference between moving assets to rebalance and moving assets to react to market chatter? The key is the emotions involved. In studies of how investors psychologically respond to swings in the market, results showed that typical investors (those who don't invest professionally), react with emotion so strongly the emotions can overcome rational thinking.

Having a long-term view on investing also involves more than figuring out how to whether a storm. It may also keep employees from making decisions that could positively impact their accounts. For some people, fear of not having enough for retirement or an emergency may keep them from investing in funds with appropriate levels of risk (and possibility of return). Those people may invest too cautiously, and the result may mean that they are leaving money on the table, and shorting themselves of a potentially greater amount for retirement. For others, the possibility of a high profit may lead them to invest in accounts with too much risk for their needs. This could mean that they put too much money that they will need soon at risk of loss.

So how can a plan sponsor help their employees make the right moves? Encouraging education about emotional investing, as a topic in itself, and creating materials with common themes that employees can access easily (such as on the plan's website or via the benefits section of the human resources site) can be helpful.

Other strategies include educating employees about risk manage-

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ment of their accounts. One topic might be to include information about diversifying investments as a method of security. Diversification, investing in a variety of stocks and other assets and investing in funds that include international companies, helps to spread risk.

Helping employees understand the long-term view also includes educating employees about compound interest. An employee's single best tool for weathering a volatile market is time. Many employees don't understand that compound interest lets them make money off of the interest they collect from their initial investment. That compounding interest can transform a $5,000 investment into a $17,000 asset in twenty years with no additional investing. Stated a different way, if an employee started saving $5,000 per year (or $415 per month) at age 27, she would have $538,547.73 by age 65. Understanding the long term, and compounding interest, can help employees feel more secure during changes in the market. ■