

Feeling Your Way to Wealth ... Emotional Intelligence in Investing

by Hugh Massie

Ask a group of investors to share the 'secret' to successful investing, and you're likely to get many different quantitatively focused answers, ranging from, hold for the long-term, diversified asset allocation, quality research to the much touted 'buy low, sell high' mantra.

**"The most common cause of low prices is pessimism... It's optimism that is the enemy of the rational buyer."
- Warren Buffett**

However, recent research into the human mind has found that the secret to success in any long-term endeavour, whether it be business, relationships or investing, is an attribute called 'Emotional Intelligence' (otherwise known as 'EI'). EI is a type of intelligence that's significantly different to the standard IQ-based definition of 'smart' we're all used to. The topic of 'EI' has received significant coverage in the business world in the last few years, fuelled in particular by Daniel Goleman's books which are aimed at helping business people use the skill to further their careers and effectiveness.

According to Goleman, EI has four facets, all of which are linked so that growth occurs in a circular fashion. The first facet, self-awareness, comes from acknowledging, recognizing and understanding your own emotions. Secondly, self-management, which is difficult to master without self-awareness, grows as a result of dealing with your emotions in an effective way. The emotionally intelligent person would, for instance, channel anger into productivity, rather than lashing out at themselves or another person. They also handle stress, disappointment and uncertainty more rationally, and don't allow those feelings or circumstances to control or initiate their decisions.

The third facet of EI is understanding others' emotions, recognizing them and responding with empathy, as well as understanding cultural or political structures, such as office politics. The fourth and final facet of EI is the ability to build quality relationships with others, effectively and appropriately motivating others, using subtlety when dealing with delicate issues, and navigating politically-charged scenarios with tact and delicacy.

But the role of EI in investment has been little publicized, even though its application can be invaluable for investors. Whether this is because the investment process is seen as an objective, numbers-based, non-emotional process, or whether the investment industry has simply not been made sufficiently aware of the existence of EI, is unclear. Certainly, we believe that both a high level of EI, combined with sound financial knowledge, strategy and advice, can make the difference between great investors and the also-rans. But sound financial knowledge will not do it alone.

What makes EI such a powerful investment tool is its ability to give investors enough confidence, focus and rationality to remain committed to their strategies even when the market value of their portfolio is declining, not living up to expectations, or being superseded by other strategies. Investors with high EI, in the long term, worry less about their investments, reap higher returns, and make fewer mistakes.

Daniel Goleman, with his co-authors Annie McKee and Richard E. Boyatzis wrote in *Primal Leadership*, "Negative emotional surges can be overwhelming; they're the brain's way of making us pay attention to a perceived threat. The result is that these emotions swamp the thinking brain's capacity to focus on the task at hand, whether

it's strategic planning or dealing with news of a drop in market share." For investors, the 'perceived threat,' whether it be sluggish investments or a drop in portfolio value, causes the brain to be overwhelmed with negative emotions. Without EI, or an awareness and ability to manage these emotions, they can and do cause havoc for individual investors, and on a larger scale, for investment markets generally.

It's a reasonably well-documented fact that chasing last year's great performers is a poor investment strategy. However, that's how many players in the investment game, even seasoned investors, have made decisions. How often do you see investors with a strategy then not stick to it? It hurts to see someone else doing better than you are, it hurts to see your portfolio performance lagging behind the investment of the moment. It's not the feeling of hurt per se that causes investment damage, but allowing it, even subconsciously, to determine your next investment move.

Several years ago, a lifestyle program in Australia staged an experiment using two presenters driving in the same afternoon peak-hour route. One of them, a professional driver, drove aggressively and hurriedly, switching lanes, barging in and accelerating as much as he could without causing an accident. The second driver, a woman, drove far more patiently, sticking to the one lane as much as she could and travelling at a moderate speed. The result of this case study was interesting. After their half-hour drive, the aggressive driver reached his destination sooner by a margin of about 60 seconds. However, he used twice as much fuel, and caused an estimated 150% more wear to his engine than the more patient driver.

This experiment is a great analogy for investors. Emotionally intelligent investors are like the patient driver, sticking to their 'lane' or investment strategy in the long-term. This doesn't necessarily mean that they'll put up with a poor investment past its used-by date, but because they have researched their strategies thoroughly, invested in asset classes they understand, and undertaken the volatility level they know they are comfortable with, these investors are able to operate above the emotional level, sticking to their plans unless there are reasonable and rational arguments to do otherwise. They take time to rationally consider their past successes and mistakes, and analyze possible consequences before making the deal.

However, emotionally unintelligent investors often let fear or panic take control, and are more like the aggressive driver, switching lanes whenever something more profitable comes along. They are often after the 'quick kill,' looking for that one deal that they're going to be able to talk about for years to come, even if this desire is subconscious. These investors often commit to investments they know little about or are not suited to, and when things don't go as planned, panic and confusion sets in – the worst possible state of mind in which to be making investment decisions. This is certainly not a deliberate strategy, but when our brain chemistry reacts to danger, it causes us to become emotionally charged – a 'fight or flight' reaction.

Another dangerous trait of the emotionally unintelligent investor, is that there's a high likelihood he or she possesses an inflated ego. Research shows that most investors believe, even subconsciously, that they have an edge on others in the market, that they have better intuition than most players and that their technique, whether it be watching stock indices, predicting the behavior of businesses or CEOs or taking the 'pulse' of the investment community, is inherently better than those techniques employed by others.

What these investors often fail to realise is that investment prices, particularly for listed stocks, are often not determined by their true value or potential, but by the

collective mood of the market. Irrational prices set by irrational traders are what create extreme bull and bear markets, and irrationality is something that, by its very nature, is unpredictable and deaf to logical reasoning. The bottom line for emotionally unintelligent investors is similar to that of our aggressive driver – little or no advantage, and significantly greater financial, emotional and physical costs.

Ask most players in the investment game which investor they would most like to emulate, and it's good odds that most of them would answer 'Warren Buffett.' Buffett is a prime example of emotionally intelligent investing. His success, in his own words, is not a result of academic-style intelligence, luck or intuition, but rationality, a key factor of EI. It was this rationality that keeps Buffett committed to his strategy. During the tech bubble, Buffett was widely criticized for not investing in technology stocks, despite their meteoric rises. His rationale was that he didn't understand them, so he wasn't going to invest in them – an approach that caused more than one of his critics to label him 'irrelevant'. But even if tech stocks hadn't had their dramatic rise and fall, from an EI perspective, Buffett still did the right thing – he stuck to his very rational and logical guns – guns which he knows intimately.

Throughout the history of investment, EI has saved many an investor, even before it had a name. During the 20's, high EI advisors such as Roger Babson, a Boston Financial Advisor, and Charles Merrill of Merrill Lynch warned investors that stocks were overpriced and heading for a momentous correction. A few wise investors, of course, knew the difference between fear or greed-driven and rationality, and heeded this good advice. But history shows that far greater numbers ignored it, listening instead to their irrational emotions – elation, craving, thrill, and eventually anxiety, panic and despair.

A significant component of emotionally intelligent investing is understanding and accepting your natural propensities to risk – not just in investing, but in all aspects of life. Let's face it, most investors have a high risk profile during a bull market, but when the chips are down it's a different story. However your inherent risk profile – how much risk you are prepared to take in your career, your weekend pursuits – is a good indication of what your inherent investment risk profile is. Sure, education and experience can help us understand broader and deeper aspects of investing, but how much uncertainty we are willing to bear over the long-term depends on our inherent propensity for risk or daring, which the emotionally intelligent investor understands and sticks to.

The good news is, though, that EI is something that can be developed. The starting point is for investors to objectively critique their own financial wiring – their inherent investing strengths and weaknesses, the factors that led to their past successes and mistakes, and the inherent personal behavioral traits that drive their investment decision-making. Through objective self-analysis, investors can seek help in weaker areas, educate themselves where necessary, and develop investment strategies around their natural aptitudes, resulting in long-term commitment and a rational, emotionally intelligent approach to investing.

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Financial DNA Resources has developed the Financial DNA® discovery process using a suite of appraisals to uncover investors' innate preferences and financial personalities. The information uncovered is then used as a platform for making aligned and committed wealth creation decisions.