THE THREE CATEGORIES OF INVESTOR

GETTING YOUR **HEAD** AROUND **INVESTMENT PSYCHOLOGY**

Being able to locate a hotspot and do the numbers are powerful skills when investing, but many investors are missing out on something a lot closer to home – their psychology. Jennifer Duke finds out how this affects them

1. THE ACTIVE BUYERS

- Positive self-image
- Take initiative
- Seek out deals
- Research extensively
- Often time-poor
- Regularly do financial 'health checks'

2. THE REACTIVE BUYERS

- Often look back and ask 'why didn't I do this earlier?'
- Need prompting
- Prone to analysis paralysis
- Dominating emotion is often confusion

3. THE PASSIVE BUYERS

- Not trusting of others
- Fear failure
- Procrastinate
- Sit and wait, often watch others
- Need "proof" that something works

While investors tend to be very aware of the importance of knowledge and skill when it comes to buying well, very few are aware of the role their psychology plays in their portfolio's success. In fact, an investor's mindset is a large part of what makes up their investments, according to Propertybuyer's founder, Rich Harvey, who has seen more than 1,000 investment transactions take place.

"Every investor is different, and for this reason their approach to investing varies," Mr Harvey says. "We should all look at our decision making process and our psychology as it will have an impact on our success. Investors can change their psychology. People think they're stuck in a rut, but they can definitely change. Your mindset with investing is everything."

This mindset and psychology is what Colin Nicholson, the founder of Building Wealth Through Shares and author of *The Psychology of Investing*, calls 'temperaments'. He believes it's very important to understand where you fit in in order to understand investing.

"You need knowledge about what you're investing in," he says, "you need to understand how to analyse the investments you're making and how to control risk. And finally, you need to understand yourself. This is where the psychology part comes in."

Most investors progress along their journey in this order, eventually realising psychology has an impact on their portfolio. Mr Nicholson says, to be the best investor, you need to think differently.

"The first critical thing is to understand yourself and who you are. Your investing experience is important, no matter what you invest in – eventually the market will turn a searchlight on who you are. It will find the weak points."

WHAT TYPE OF INVESTOR ARE YOU?

To be able to control your psychology and approach to investing, you must be able to identify the type of investor you are. "It goes hand-in-hand with your general life and occupation," says Mr Harvey.

"For instance, if someone's profession is accounting, they're likely to be looking at the numbers. If someone is an actress, or their work involves a lot of emotion, they tend to possess this sort of character."

Essentially, it's worth looking at it as a type of 'scale' (see sidebox over page). This is especially the case if you are a new investor. The scale varies from the 'go-getter' – the type who's 26 years old and says 'I'm going to make $4 million by the time I'm 40' – with a definitive goal, to the 'ultimate procrastinator' who tends to make a lot of excuses and may never even purchase.

Investors are rarely stuck in one category, and move around the scale throughout their investing careers. The best investors, however, aim to move themselves from either end of the spectrum to stage three – the proactive investor.

THE SCALE OF INVESTORS

Source: Propertybuyer

1 - THE PROCRASTINATOR

If you find yourself making excuses, such as "I don't have enough money" or "I don't have enough time", you may well fall into this category. Similarly, overly focusing on negatives, such as the market downturn, or the possibility of losing your job due to the nature of the economy, are also traits of the procrastinator.

TIP: It may take missing a few deals and seeing missed opportunities for an investor in this class to get active. Review the growth of deals you have said 'no' to in order to motivate yourself.

2 - THE CONSERVATIVE PLOTTER

These people invest "on the side". They might do a course or two, and look to dabble in property. These investors tend to manage to buy one property, possibly two, and then they find themselves stuck, or back at stage one.

TIP: Consider a mentor, or associating with more bullish investors. Set yourself specific goals and time frames to complete actions within.

3 - THE PROACTIVE INVESTOR

This is the ultimate type of investor. They have a plan in place, clear goals and are mindful of their financial situation. They form the balance between stage one and stage five. All investors should aim to be in this category.

4 - THE OPTIMISTIC INVESTOR

These investors are keen to do the right thing, but often find themselves skimping on the due diligence as they have a bit of blind faith their investments will do well. Investors in this bracket may need to miss out on a better opportunity to be able to curb unfounded optimism.

TIP: Take extra time on your due diligence, and ensure you can fill in the 'cons' section of the investment.

5 - THE GO-GETTER

They often run ahead of themselves without doing the proper research and taking the time to learn. They may find themselves, or have found themselves, buying the wrong kind of property. Often, people end up in stage five directly after doing a course or seminar.

TIP: Decide to wait a day before confirming your decisions, and spend that time thinking about it. This will help you make sure you're not rushing into an investment. Find yourself a 'devil's advocate' or ask someone to play that role for you, asking any questions you might find difficult.

COMMON PSYCHOLOGICAL PITFALLS

Co-owner and managing director of Wealth Focus, Sulieman Ravell, explains that 'loss aversion' is one trait worth analysing.

"We hate to acknowledge loss and we'll hold on to a bad investment for too long," he says of human nature – and a majority of investors.

When it comes to real estate, a relatively expensive asset, emotion can understandably run high. For this reason, your tolerance for 'risk' and the perceived potential for loss, are absolutely crucial to consider.

Mr Nicholson agrees, saying "The first thing people need to understand is markets do fluctuate. Without appreciating there's always a risk, you're like a blind man going forward.

"The risk of loss is generally much more powerful than the pleasure of gain. When people get a profit, they snatch it. Yet when they get a loss they ride it, and hope it will 'come good.'"

Mr Ravell notes there are a number of studies showing that loss and gain, over the long term, end with the same "happiness" result.

"There was a study on the happiness of lottery winners, who were asked to rate their happiness from one to 100," he says. "As you would expect, immediately after they won the lottery they were extremely happy, with scores at the top of the range.

"They were retested a year later and their scores had reduced to the middle of the range."

Similarly, a separate study looked at the happiness levels of new paraplegics. Their initial levels were low, but they were tested a year later and their scores had also reached the middle of the range.

"From an investment point of view, it explains why we tend to be more reticent to sell poorly performing investments – the pain of loss diminishes the further away we are from it," he says. Investors who can understand this, and take a step away from their emotions, will be better placed.

There are a number of other 'human nature' traps when it comes to investing, because often our primal instincts don't match up with the best investment decisions.

"The best investors in the world are generally those who can distance themselves from behavioural biases," Mr Ravell explains.

He points to one of the most common failures of investors as being a habit called 'anchoring'.

"This is where we fixate on a target or previous trend," he says. "This could be a suburb's five-year growth. We look for trends in everything we do, rather than making logical decisions."

Another common trap is 'over-confidence', explains Mr Nicholson. This psychological term is one that has been reviewed in many studies and has frequently found that the lower a person's level of intelligence or knowledge of a subject, the more 'over-confident' the person tends to be about it.

"That is, we tend to be far more confident than we have any right to be," he laughs. "You don't know what you don't know, and when you're investing that's very scary. You might invest without doing your research, and you may be lucky once or twice."

This 'lucky' accident when investing, which was very common when the property market in Australia boomed, gives rise to yet another psychological pitfall.

'Confirmation bias', also known as 'peer reassurance', can be hard to see in your own life, but it is undoubtedly there and has more effect if you don't appreciate we are all subject to it.

"You see a nice property and you think you want to buy it. You say 'I think I'll ask my friend because they know something about it', and if they agree with you, you'll become more confident," explains Mr Nicholson.

"Instead, you actually want to be speaking to the person who doesn't agree with you – and often people don't want to do this."

Articles that confirm your point of view, and other sources that agree with you, somehow become more prominent in your mind and you are able to ignore facts that shed doubt, without noticing it.

This is where a 'devil's advocate', who can question your opinions and pose differing points of view, can be useful. Also, a 'pros and cons' list can be a good starting point – although you'll still need someone to help you with the cons. Most of these traits are completely natural to humans, and we learn them during the course of our lives.

"The people who are aware of them are the people who make the best investors; they start catching themselves in the act," he says.

"As a result, many investors have worked out strategies to ensure they don't fall into the psychological traps."

WHAT YOU CAN DO

"If you believe you're going to buy a dud investment, you probably will because all your brain waves are attuned to buying a dud investment," says Mr Harvey. "If you're attuned to a great investment, looking for good numbers and good advice, then you'll do well. You need to do your numbers, analyse your budget well, and then execute."

Getting attuned to your own mindset can be difficult. Watching how successful investors work is one step, while seeking out mentors and networking are powerful considerations.

"Your parental influence and your peers have a big impact on your psychology as an investor," he says. "If an investor runs off in their own direction without testing or measuring what they're trying to achieve, they won't achieve it. Get independent advice and test that advice."

Mr Nicholson agrees with this approach: "Sometimes asking someone who knows a lot about your subject, such as a more experienced investor, can help," he says. "Ask them what can go wrong and what may not be right – someone who's knowledgeable and agrees with you can also be asked to provide the other side of the picture."

The other trait of the best investors is having a plan. Do this from the start. "Write it down and refer back to it," says Mr Ravell. "Keep reviewing your investments against your initial plan. This will keep you sane."

And, importantly, allow yourself to make decisions that don't work out, and learn from them.

"A lot of the time, people do the work and invest on sound principles but it doesn't work out. That's not necessarily a mistake. If you haven't done the work properly, that's the mistake," says Mr Nicholson.

In the long run, a majority of investors will never consider their psychology as being integral to how they invest; yet a majority of investors will also not achieve their goals. ■

THE MOST SUCCESSFUL INVESTORS...

Find the best investors they know, or can research. They'll find they are adaptable, but tend to stick to their rules. There's both "an element of entrepreneurialism", says Mr Harvey, and "calculated risks", where they have balanced both the upside and the downside.

ASK

- What are their decision making criteria?
- How did they get to their current position?
- How are they different from other investors?
- Which parts of their approach can I adapt?