Emotional Discipline is the Most Critical Aspect of Investment Journey

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When we hear "emotion," we attach a human experience to terms such as joy, cheerfulness, fear, and anger. From an evolutionary perspective, emotions are considered "rational" as they enhance our chance of survival. For instance, the fear we experience when we see a bush shaking triggers an involuntary response to step back. In most instances, there may be no apparent threat to our life, but in the rare case where a poisonous snake is present in the bush, the response triggered by fear can save our life. While emotional responses benefit us in the wild, they can lead to poor decision-making when transacting in financial markets. Hence, it becomes crucial to act in a disciplined manner so that our emotions don't trigger actions that reduce our wealth. In the article, I will highlight instances/scenarios where decisions purely based on emotions may be sub-optimal. While the article will not offer any ready-made solutions on how to deal with biases, being aware of the shortcomings of our decision-making process can help us analyze our choices more objectively.

Every day, we are bombarded with stock tips by financial analysts and investment gurus regarding what to buy/sell. As retail traders[11], we tend to react to every piece of news that grabs our attention, thinking that we ought to trade based on it or otherwise lose out. Colloquially this is also called fear of missing out (FOMO), but it stems from overconfidence that we can identify the information content of a particular news item. Furthermore, we are overly sure of our ability to take advantage of such information and trade, thinking that we can beat the other market participants who have access to the same news item. But empirical research on trading behavior unequivocally documents that excess does not result in higher returns (Barber & Odean 2000, Barber, Huang, Odean, and Schwarz 2021).

In a tweet in January 2022, Nithin Kamath, the founder of Zerodha, stated that only 1% of active traders make more money than bank fixed deposits over three years.[12] Does it mean that retail traders should not participate in the stock market? The answer is no. Nevertheless, they need to be cognizant that they are at the mercy of the broader market, and trying to time the market is futile.[13]

What Kamath said about Zerodha's users is also valid for US traders, specifically Rohinhood traders. Barber et al. (2021) document that most actively traded stocks by the Robinhood traders underperform the S&P 500

[11] I use the terms "trading" and "investing" interchangeably in the article. Same for the words "trader" and "investor."
[12] Link to Nithin Kamat's tweet: https://twitter.com/nithin0dha/status/1478260639105622019
[13] Timing the market refers to strategically buying an asset when its price is below its fundamental value and selling it when its price is above the fundamental value.

index. In other words, if Robinhood traders had invested their money in passive index find, they would have been better off. Furthermore, market participants who trade excessively earn a lower return (Barber & Odean, 2000).

So why do people trade excessively and earn lower returns than buy a passive index fund? The answer is that there is no scope for seeking a thrill from passive investing. On the other hand, regularly following the developments in the stock market and trading based on tips theoretically gives us a chance to beat the market (despite being statistically unlikely). Hence, when combined with our overconfidence, the need to seek an adrenaline rush results in excess trading.

Put differently, trading actively in stock markets satisfies the urge to participate in a lottery, which becomes a source of thrill-seeking. Furthermore, the most popular products demanded by retail traders have lottery-like characteristics, such as stocks with a right-tailed distribution, IPOs, and out-of-the-money options. Such instruments have a small probability of earning extremely high returns but have a negative expected return. While retail traders focus on the possibility of earning high returns, they ignore the negative expected returns from such financial instruments.

Worst of all, retail traders exhibit trend-chasing characteristics; they enter the market following a period of high equity returns and exit the market after a steep decline. Put colloquially, retail traders buy high and sell low, which is a quick way to lose money. Rather than taking advantage of financial markets by investing to grow their wealth over the long period, people lose money by unsuccessfully chasing trends over the short period. Many retail investors, scarred by their memory of losing money in stocks, may never invest in equity again.

As commonly advised by many knowledgeable investment advisors, the best way for retail traders to invest is through mutual funds. If confused about which fund to buy, the simplest is to buy an index fund. Such a strategy has two advantages, (i) investing in index funds is cheap as the expense ratio is minuscule, and (ii) usually, they do not carry an exit load.

Another reason retail investors should consider index funds is that there is no evidence to suggest that a particular fund manager can consistently beat the benchmark index. A fund manager outperforms in some years and underperforms in some. Overall, it is improbable for a retail investor to pick a fund manager who can consistently beat their competitors. Hence, rather than getting confused by the plethora of choices available in the active fund category, retail traders can invest in passive funds. The critical point is to invest consistently and for an extended period.

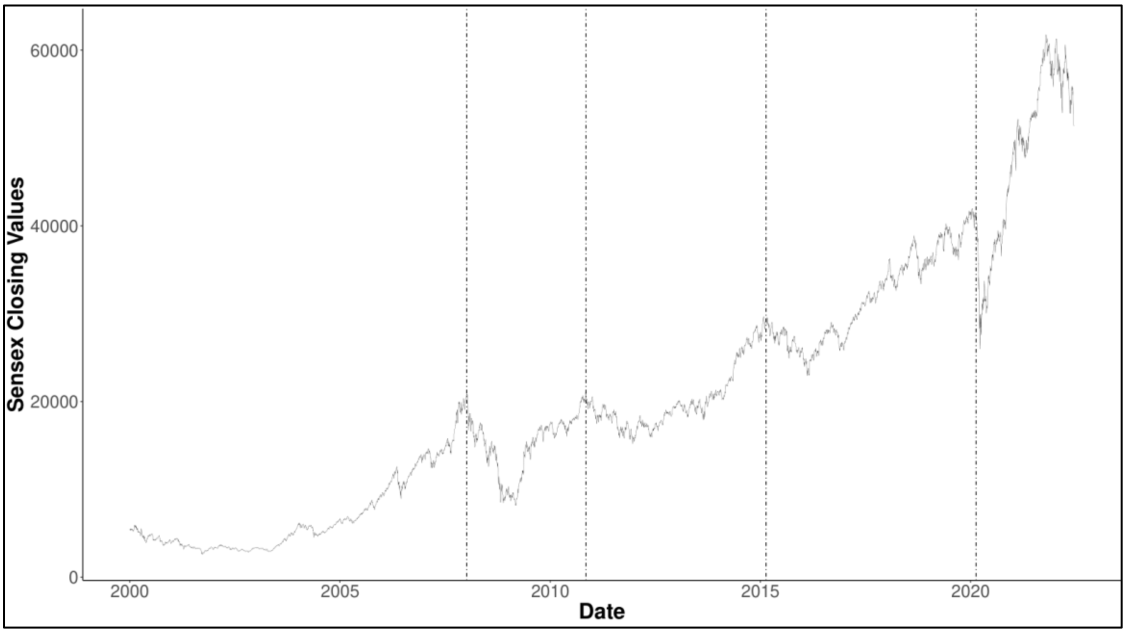
Consider an investor who invested in the market at the worst possible time, just before a major crash. For the sake of this example, I will assume the dates of investment to be January 8, 2008, November 9, 2010, February

19, 2015, and February 19, 2020. Details of the crash following these dates are provided in Table 1. A chart depicting the BSE Sensex index's closing price and the dates preceding the major crashes is in Figure 1.

Table 1: Major Crashes of Sensex

Date of crash	3-month returns	6-month returns	12-month returns
January 8, 2008	-24%	-33%	-56%
November 9, 2010	-16%	-12%	-18%
February 19, 2015	-6%	-6%	-20%
February 19, 2020	-22%	-6%	23%

Figure 1: Major Declines in Sensex



All four instances are characterized by a significant fall in the index, with the most severe being the 2008 crash. In the 2008 crash, the market fell by 24% over three months and 56% over a year. The fall in Sensex on the announcement of the Covid lockdown was similar, with the index falling by 22% over three months. However, the recovery was far quicker, with the markets ending up +23% by February 2021.

Table 2 documents the recovery of Sensex over seven years following the crash. The values indicate that Sensex not only recovered the loss but also posted phenomenal returns over a long period.

Table 2: Recovery of Sensex after Major Crashes

Date of crash	2-year returns	5-year returns	7-year returns
January 8, 2008	-22%	-5%	40%
November 9, 2010	-12%	22%	59%
February 19, 2015	-2%	16%	96%
February 19, 2020	39%	NA	NA

Keep in mind that for constructing this artificial example, I had assumed that the investor entered the market at the worst possible time (right before a major crash) and invested a lumpsum amount. The picture would have been far more attractive if the trader had instead invested regularly via SIP in any Sensex index fund (Table 3).

SIP stands for Systematic Investment Plan, where investors can contribute a fixed amount at a monthly/quarterly frequency in a particular scheme. For example, in the case of a monthly SIP, a fixed amount of money flows into a mutual fund on the same date every month. Depending on the NAV of the fund, the appropriate number of units are allotted to the investor.

Table 3: CAGR of Monthly SIP Starting from the Date of the Crash

Date of crash	2-year returns	5-year returns	7-year returns
January 8, 2008	11.86%	4.21%	7.29%
November 9, 2010	3.31%	5.68%	5.19%
February 19, 2015	0.65%	5.81%	8.41%
February 19, 2020	16.57%	NA	NA

The figures in Table 3 clearly show that even during the worst possible crashes of Sensex, if retail traders had continued with their SIPs, they would not have lost money in any of the instances. Hence, maintaining the discipline to invest regularly even when the market is plummeting is not a bad strategy. The fear of losing wealth can highjack the rational thought of continuing with the SIPs. Hence, retail traders are also given counterintuitive advice not to look at their portfolios very often. The more a trader looks at their portfolio and follows the market, the more likely they will liquidate their portfolio when the market crashes. As a result, retail traders may withdraw their money from the market at the worst possible time.

While investing via SIPs helps us avoid making poor financial decisions due to our overconfidence and fear, it also helps us guard against another common bias – the tendency to over-extrapolate. In financial markets, participants extrapolate the returns experienced in the past to continue into the future. Greenwood and Shleifer (2014) document a high degree of correlation between what the respondents forecast about future returns and what they have experienced in the recent past. Following a period of high returns, people expect the market to give high returns in the near future as well, but more often, the opposite happens. The researchers also document a strong negative correlation between what people forecast and what is realized.

In other words, when people expect high returns, the market performs poorly, and when people expect low returns, markets usually do well. Greenwood and Shleifer (2014) provide very strong evidence that we are terrible at forecasting the future. But why do we continue to extrapolate the past into the future? The answer again lies in the evolutionary process. From an evolutionary perspective, repeating a strategy that worked well in the past made sense in the wild—for example, avoiding an area where a predator was spotted or repeatedly going to a place where essential resources such as food and water were found previously. Essentially repeating a successful strategy and avoiding a failed strategy makes perfect sense when one understands our evolutionary origins. However, financial markets are different. More often, a period of high returns is followed by a period of low returns and vice versa. Hence, extrapolating a previously observed trend into the future leads to erroneous forecasts. When we invest via SIPs, we naturally refrain from the urge to study the past trend and make predictions about the future. Hence, the tendency to time the market also diminishes if one invests on a fixed date every month, irrespective of the state of the market.

Hence, the financial markets are the last place where we should seek thrill and try our forecasting skills. As iterated by many professionals, the more boring the investment journey, the better the likelihood of achieving the investment objective. Therefore, maintaining emotional discipline during the journey is more important than spending time and energy picking funds and fund managers.

References

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