

Investor



Get off the
sidelines.

Has the recent
market turmoil left
you wondering how to
invest for the future?

Don't worry, you're
just being human.

by Rod Greenshields

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Humans are hardwired to flee danger. The part of our brain that responds when we face mortal danger also processes financial losses.

Understanding what makes us human just might help us become better investors.

Harness the power of emotions to reap the rewards of investing.

The fight or flight response is one of many that researchers have discovered about the human brain and how it measures rewards, calculates probabilities, and evaluates risks.

Brain imaging technology can highlight what happens to our brains when we invest. These images show that our investing brains often spur us to take actions that make emotional sense, but aren't based on logic. So, it's easy to see how sharp declines in the financial markets spark investors' fear, often leading them to instinctive decisions to pull out.

It's our nature to react more to changes than to what remains constant – for the concrete and the intangible. For example, we notice a moving car far more than a parked one. And we stop feeling a watch on our wrist if we've worn it awhile. That's why it's generally easier for us to focus on a single stock's rise and fall rather than changes in our portfolios over time. The makeup of our brain leads us to do more of what improves our odds for survival and avoid what feels risky. It's no wonder then that in a drastic downturn, people make quick decisions to move their money out of the markets or stop contributing to their retirement plans to avoid further loss. We aren't being irrational, just human.

But the stock market's inherent risk is what offers the possibility of financial rewards, including the potential for higher returns compared to other major asset classes, such as bonds and cash. Without that risk, there can be no reward: they're simply two sides of the same coin. A better understanding of our nature may lead to a different approach to investing.

Don't miss market rebounds

One thing is certain, if you aren't in the market you won't be hit when it falls, but you'll also miss the upswings. And you likely can't reach your financial and retirement savings goals if you aren't invested. History shows that bursts of solid growth follow periods of economic trauma. If you aren't in the market, the challenge is to figure out exactly the right time to jump back in. Market timers generally

fail. By the time they realize the markets are rising, they've missed out on a good portion of the gains.

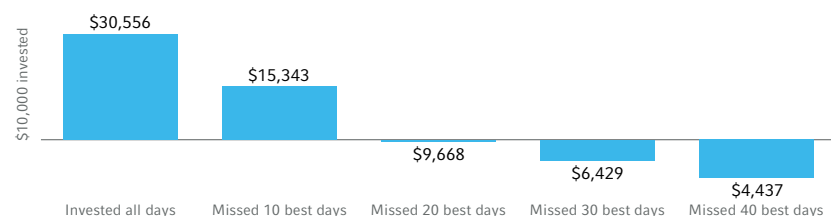
An investor with \$10,000 who missed out on only 20 of the best-performing days in the market would have ended up with a portfolio worth \$9,668, about 70% less than one who stayed invested throughout the period, earning \$30,556. An investor who sat on the sidelines even longer—40 of the best days—would have lost out on portfolio gains of about 85%, compared to one who stayed fully invested.

In turbulent times, our investing brain's nature is to pull back. But these crises can be some of the best times to enter or be invested in the market because the prices are low, and you'll be able to take advantage of gains as the downward trend reverses.

FIGURE 1

The impact of missing a few key days can be costly

January 2, 1994 to–September 30, 2009



Source: Russell 3000® Index

This hypothetical example is for illustration only and is not intended to reflect the return of any actual investment. Investments do not typically grow at an even rate of return and may experience negative growth.

Instead of fleeing or freezing when markets drop, plan ahead to manage risk and return

› Reconsider your approach to risk

No one's risk tolerance stays the same forever. Many factors can skew an investor's perception of risk, including current market conditions. In research about how humans make decisions and handle risk, psychologists Daniel Kahneman and Amos Tversky noted that when it comes to gaining and losing money, losing money feels twice as painful as gaining the same amount feels good.

Because of this difference in feelings, it can be difficult to accurately assess risk tolerance. Risk tolerance also changes based on daily circumstances.

Consider expanding your view. Examine your position in terms of a risk profile rather than tolerance. Assess not just your willingness to take investment risk, but your need for the potentially higher returns that taking risk may bring. A large, long-term goal, such as saving for retirement, probably requires you to take some measure of investment risk. Perhaps more than you're comfortable with in the aftermath of the recent market crash. But it's unlikely you'll be able to meet your retirement goals without taking advantage of gains that can come from the stock market.

To determine how much risk you may need to take, outline your goals by dividing them into essentials, lifestyle and estate categories. Essentials are the minimum savings you need to satisfy basic living expenses. The lifestyle category covers discretionary expenses, such as travel and recreation, and the estate category includes the inheritance you'd like to leave your heirs.

› Establish a personal investment guideline

An investment policy is a statement you create with your advisor that considers your investing comfort level and outlines how you'll accomplish your goals using a mix of

investments. For example, set target ranges for how much money you want to keep in various investments. Agreeing in an unemotional moment to set and maintain a balanced mix helps you avoid sharp losses even if one asset class, style or sector declines.

› Create a fully diversified re-entry strategy or review and adjust a current portfolio

As you rethink your investments, a financial advisor can serve as a neutral third party. An advisor can help you assess your goals, your current savings and investments, and options to adjust your spending and savings rates. Then, based on your unique situation, you'll set up a plan to invest or adjust your existing strategy. Remember to regularly monitor your plan and set metrics that measure your progress as you meet specific objectives.

Re-entry strategies

As you balance your appetite for risk with your financial goals, ease back into the market by investing a fixed amount of money at regular intervals over a long period. Over time, your portfolio reflects an average cost per share. This can smooth out your investment returns long term and eliminates the impossible task of perfectly predicting when the markets will hit their peak or bottom out.

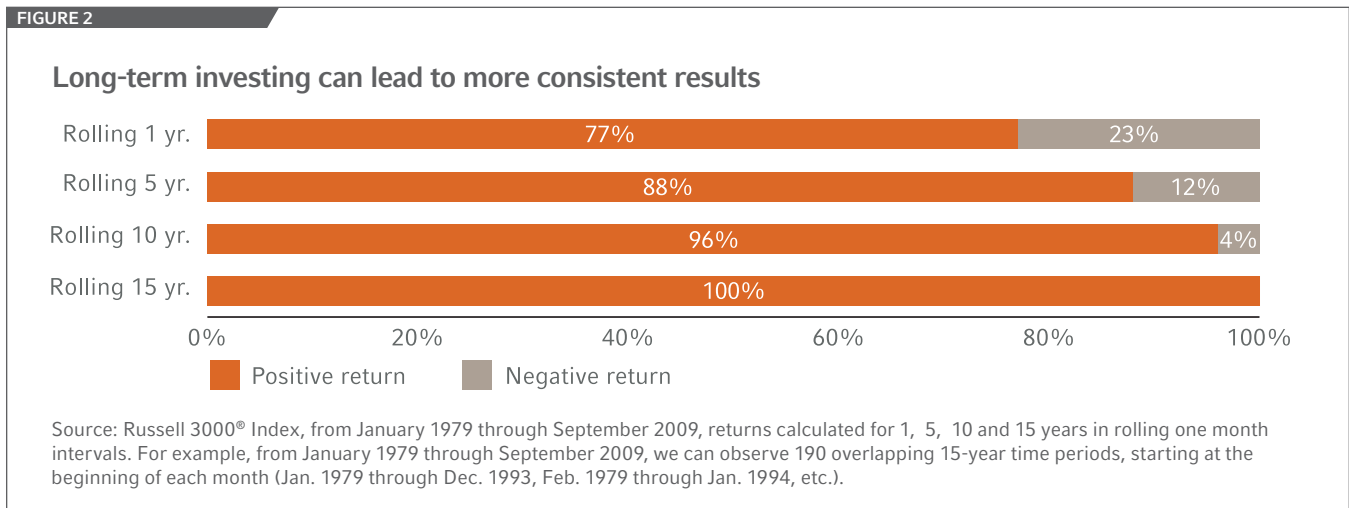
Investors who maintain consistent monthly contributions to their employer-sponsored retirement plans, such as 401ks, are essentially practicing this strategy.

Surviving and thriving

Markets will always fluctuate, but time helps reduce the impact of market fluctuations on your portfolio.

Steady investing based on a fully diversified strategy may not seem glamorous but it's likely a more realistic way to meet your goals. Your instincts can be a powerful force for survival, but when it comes to managing our money, taking a measured approach can serve you in the long term with more consistent results.

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Logic and emotion both have a place. But it helps to be aware of these **COMMON INVESTING MISTAKES:**

- 1. Market timing.** It's tempting to avoid something that seems fraught with peril until you're sure it's safe. But winning returns by predicting market cycles is rarely successful.
- 2. Over-concentrating** in any one investment or asset class. It's natural to want to hold on to a stock that's doing well, but retaining too much of one investment or asset class will foil your strategy to diversify.
- 3. Chasing the latest hot investment.** When it comes to risk and reward, it's our nature to follow the cues of others to improve our odds of survival. But the latest hot stock could be a passing fad about to peak.
- 4. Investing on a whim, hunch or tip.** Intuition has its place, but it should be secondary to facts and fundamentals.

Rod Greenshields is a consulting director for Russell Investments' U.S. private client consulting group. Rod is responsible for the delivery of tailored consultative expertise in the areas of investment management, practice management, and capital markets insight to Russell's most important distribution relationships.

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