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Overcome your instincts to become better investors

In the course of my work over the years, I have discovered something rather sobering: human beings are generally not astute investors. This is because our brains have been pre-programmed to react a certain way to a particular kind of stimulus as a result of evolution. Unfortunately, following our instincts can potentially lead us to financial ruin when it comes to making investment decisions.

Now, under normal circumstances, our instinct for fleeing danger, often before the threat materialises, will save us from many predatory dangers. However, this fleeing instinct can be counter-productive when it comes to pursuing better investment returns. In fact, it has proven to be detrimental to the making of prudent investment decisions.

Actually, our instinctive ability to recognise patterns quickly has often resulted in what is commonly called the "gambler's fallacy" among investors. To see how this comes about, let us take a coin that has been tossed three times. If it appears to be heads each time, many will probably reason that it will still be heads after the fourth toss. Meanwhile, a smaller group may reason that it will be tails, as the odds are against another heads outcome.

In actual fact, the reasoning either way is fallacious because the chances of it being either heads or tails is always 50 per cent, regardless of the outcome (or number of) previous tosses.

If a similar pattern occurs in the investment market, and we follow our natural instincts accordingly, it may well prove to be detrimental to our financial well-being. For example, if the value of a particular investment or the market as a whole is going up for no apparent reason, many investors are likely to reason that it will continue to go up. They end up buying more stocks at higher prices, but the risk of losing is actually rising even though the opposite may appear to be true. In the end, the stock or market may actually crash, thereby wiping out any gains that may have been chalked up earlier.

The key reason for this is that our minds have perceived a pattern and because the pattern appears to hold, we end up being tricked into thinking that the pattern will continue to repeat itself. This is where there is a schism between real and perceived risk. And the broader the schism, the more financial damage it can wreck on an investor's portfolio.

Conversely, if the stock or market is doing poorly, investors may reason that it will continue to do poorly and they should therefore sell. But what many fail to realise is that stock market volume is typically lowest during a trough and highest during a peak. So they heed their instinct to flee and end up buying high and selling low, when they should do the exact opposite to make money.

Therefore the most successful investors are those who are able to overcome their innate fear and greed during wild market cycle gyrations, and discern real risks, as opposed to perceived ones. They also have a keen awareness of their limitations and predictive powers. Among other things, this includes the ability to recognise that they can sometimes lose money momentarily for doing the right thing, and make money for doing the wrong thing.

Meanwhile, associating the wrong reasons with a profitable trade can be damaging to our investment quotient in the longer run. On top of that, we must never forget that the markets are full of predatory players who make a living out of having small investors for lunch. These professionals do so well because they are experts at tricking retail investors into reaching the wrong conclusions.

As such, to do well in the investment game, investors must be keenly aware of their instinctive ability to detect a pattern and react accordingly, and overcome this instinct. Only then can they raise the probability of scoring gains in the game.