



Overcoming a Force of Nature

It's an investment dilemma. In tough markets, investors are sometimes wracked by fear and anxiety raising the question; are either of these emotions helpful?

Feeling fear can be a healthy response to real danger for which you can prepare a plan of action. For example, if you meet a bear in the woods, this is a real danger which is accompanied by fear. As the cowboy stranger says in the "The Great Lebowski", "Sometimes you eat the bear (*sic*), and sometimes, well, he eats you".

The fear we feel when confronting the bear is real and healthy and should be handled accordingly. You don't chase or approach a bear at close range. You shout, wave your arms, bang pots and metal objects. You stand your ground hoping the bear will go away sooner or later.

Feeling anxiety over the possibility of encountering a bear is another story entirely. It may cause you to exaggerate danger and lead you to make irrational decisions. Perhaps you would avoid going the woods forever.

In today's modern world, the chances of meeting a real bear are unlikely, but a type of bear that investors will **always** encounter is the bear market.

Which emotion does a bear market instill in you? Fear (healthy) or anxiety (unhealthy)?

If you are feeling fearful, you can take appropriate action.

1. Identify the fear. If you fear losing your money permanently, assess whether the failure of any one investment would irreparably harm your overall wealth. Too much in one stock? Sell some and redistribute among others. Mutual funds or index funds are a good way to diversify. Healthy fear. Healthy reaction.

If you are feeling anxious, consider the following:

Your investments are already diversified and any single company's disaster will not hurt you too much---but you're anxious and tempted to sell everything when the markets decline. Selling when the market is low may cause permanent portfolio damage so recognize this as anxiety and keep the big picture in mind. Remember markets and economies are always cyclical. Stay put until things recover.

Another Mental Trap: Extrapolation

Extrapolation is the taking of recent current events and projecting them into the future.

In the 19th century a London magistrate complained that the filth from the growing number of horses crowding the streets would create unbearable health problems and disease. This person was extrapolating the current horse population straight out into the modern era, unaware of the changes in transportation which would take place a few decades later.

In 1999, stock prices had been going up double digits for 4 consecutive years. Investing seemed easy and the media paraded a number of gurus who declared the "death of the business cycle" due to the invention of the internet.

Two unprofitable internet companies, CMGI and Internet Capital Group were worth more than the combined value of International Paper, Alcoa, GM, Honeywell, AT&T and Eastman Kodak because investors were extrapolating a continued advance in stock prices. Unfortunately, they were doing this right at the time stock markets were beginning to collapse. Three years later when the Dow fell to 7,286 many were extrapolating a further vicious decline. One year later the Dow had increased by 32%.

How to Stop Extrapolating

Reorient your thinking by contemplating an idea called "reversion to the mean". "Reversion to the mean" suggests that after an extreme move, prices will bounce back. This idea can give you the courage to enter a bear market when you least want to and exit a bull market as well.

When Warren Buffett says: "Be greedy when others are fearful and fearful when others are greedy", he's counting on the reversion to the mean.

Sounds simple, doesn't it? All you have to do is avoid these two mental traps and you could make a load of dough. Be warned, the mental traps of anxiety and extrapolation are a force of nature. If you are one of the few who can conquer them you may become the next Warren Buffett. Good luck!