Psychological traps of investing

Investors can sometimes make irrational decisions because of their past experiences. Here's how and why it happens, and some ways you can avoid it happening to you

When we make a decision, there's something we just can't avoid: our own history.

We learn from our prior experiences either through reinforcement – which is when we've been rewarded positively, or through punishment – when the results have been negative.

"We will have made similar decisions before and been either rewarded or punished psychologically by what happened as a result. We will also be influenced by what we have seen others do and the results we saw them experience," explains Colin Nicholson, author of *The Psychology of Investing*.

"When the learning is by watching others, psychologists call it vicarious reinforcement, or vicarious punishment," Nicholson adds.

The reinforcement trap

Margaret Lomas, financial planner and author, comes across many property investors in her line of work and she has seen these patterns played out plenty of times. She saw a recent example of the reinforcement trap when clients invested in a particular town.

After they bought, prices skyrocketed. Not only did they get good cash flow, they also got growth straight after purchasing. This positive outcome suddenly reinforced that their decision to buy in that particular town was a good one.

The situation in that town was one driven by what Lomas calls those extrinsic growth factors – where the growth is driven by external investors buying. And it only takes a short period of time before the cash flows diminish because the yields drop as the values rise, but returns don't.

The opportunity for future growth is also incredibly limited because once

the people from outside stop buying, there is nothing else to drive growth.

"A lot of these clients went on and bought two or three (properties) even though we said to them, 'You bought one and that's great. Now try and emulate your success but with a different area,'" Lomas says.

TIP

Do your own research – don't just buy based on the cash flow you have been quoted

She argues, "It wasn't the area they bought in that was good, it was the decision to buy there at the time they bought that was good."

Rather than learn from that experience and be able to do it again somewhere else, Lomas believes people want to do it exactly the same as they did the first time around.

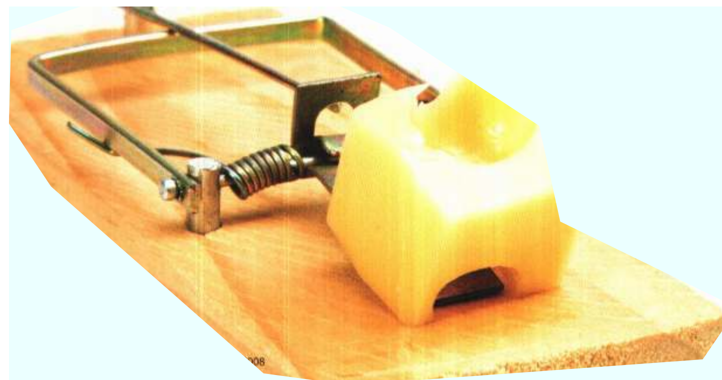
Alas, a few over-excited investors poured more funds into this particular town even though the investing landscape had changed and it was now impossible to recreate their early success. Needless to say, their subsequent investments didn't do that well.

"Certainly anyone who then followed them to that area didn't have anywhere near the good experience that they had had (originally)," Lomas recalls.

So it's a great idea to repeat a successful strategy, but that doesn't always mean buying in precisely the same location over and over again.

The punishment trap

Lomas also comes across many investors who have been punished by their previous investing decisions. These are the people



who have a "hard luck story" about property.

"They won't buy property again because they believe the fault lay with the property they bought specifically, and with property investing generally," she says.

For example, Lomas recalls one investor who purchased a hotel room in a coastal area. The investor was lured into the deal because the developer was forecasting a strong return, based on an 80% vacancy rate.

They made the decision purely based on the return that was being quoted.

Lomas believes they paid probably 40% more for the property than they would have for the same size unit as a standard residential, had it been next door.

There was about 19% occupancy in the first year, and the management company went into liquidation. The investor had borrowed the whole purchase price and it was now worth less than he'd paid for it. He couldn't sell because there was virtually no return – so no one wanted to buy it. He also couldn't lease it as a residential property because it had no kitchen.

He then turned around and said, "that's it, I've had my foray into property investing and I'm never going to invest again".

that area if he needed to rent it out as a residential unit. And he should have found out about the financial backing of the organisation.

"There are a whole lot of questions that really should have rung alarm bells in his mind had he done the research and not just been buying based on the (quoted) cash flow.

"He thinks that the reason he shouldn't invest in property is because property investing doesn't work. But in reality, he did it badly. And I can understand why he can't accept that, because it's difficult to say, 'I was wrong'."

So there's an example of someone who is punishing himself for a poor decision. Instead of learning from his mistake and getting back out there, he was scared away.

Similarly, people can be scared off just by observing the mistakes of others. When Lomas attends an expo, she tends to chat with a lot of people who have been vicariously punished.

"The comments will be things like: 'my brother got into all of that stuff and he lost a lot of money and there's no way I'm going to follow him. You can't make money from property.' I try to say to them, 'Possibly your brother didn't take the right process – you can do it, but do it well, by taking the right process.'"

Lomas believes property rarely fails

Lomas explained to the investor that had he done his due diligence, he would very quickly have decided against this investment. Investors need to have a list of questions they ask before making any investment. (As a guide you could refer to her book *20 Must Ask Questions for Every Property Investor*).

Lomas believes this investor would never have got past the first question: what is the cash flow going to be, based on independent research? He should have asked what the demand was like in

the investor. Rather, the investor can fail property by not taking the right process when they buy it.

Avoid the traps

Nicholson suggests that investors should keep a diary in which they write down the honest reasons for any decisions they make about buying or selling their investments. They should also record the reasons the investment worked or failed.

He believes this helps to keep per-

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>
> – MARGARET LOMAS

spective on why prior experiences may not be relevant to new situations.

What worked?

If the town investors had written down the reasons for their initial investments, they would have pointed to the excellent returns available at the time. This objective record might have warned them against future purchases when those returns had diminished.

What didn't work?

A written diary gives you the chance to be completely honest with yourself. This is particularly important when an investment hasn't gone well.

Lomas believes you need to "isolate the real reason the decision went wrong." If the property was never going to be any good, because your decision making process was flawed, then you need to "own up to that decision".

So, you can own up to your mistakes and make sure you never repeat it. Or you can blame the property, or the property market, or the real estate agent… and never invest again.

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Learn from Margaret Lomas, buy her book on page 91.

Checking things out

If you make a bad decision in your property investing, it might put you off all together. But it's easy to avoid making bad decisions in the first place.

You can't just rely on a glossy brochure and believe everything the salesperson tells you. You have to be prepared to do a bit of research yourself.

Consider all the available data. For example, find out about vacancy rates, prices achieved at recent sales, average rents for the area, future development plans, the general economic health of the city.

Pay for a building inspection to uncover any serious defects in the property.

Speak to local property managers to find out what sorts of properties, in which specific locations, are in demand. And are there any localities tenants tend to avoid?