Foresthill Financial Planning Ltd
Investment Process
Procedures Manual

A Consistent & Structured Approach to Portfolio Construction

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1. Introduction

Investing is inevitably an emotional endeavour. Unless schooled in the principles of behavioural finance, most investors will at certain points unwittingly undermine portfolio returns through irrational actions (which may appear rational at the time).

Our goal as an adviser is to improve upon the return shortfall that investors generally experience, by means of a disciplined and structured approach to investing, which includes the following steps:

- Thorough risk profiling,
- Asset allocation,
- Fund selection,
- Rebalancing, and a
- Structured approach to investment communications.

This document outlines our approach to each of these critically important areas of wealth management. Before detailing the investment process at Foresthill Financial Planning Ltd., it is important to outline the investment principles which guide our thinking and beliefs about investing.

All of our investment activities operate according to the unifying philosophy outlined below.

2. Our Investment Philosophy

1. ***Asset allocation approach which incorporates a Multi Asset platform***
2. ***Value principles***
3. ***Process over outcome/result - Long term investment process over short term results***
4. ***Rebalancing on a regular but practical basis***
5. ***Active management V Passive management***
6. ***Applying overall philosophy at appropriate levels of risk for the particular individual***
7. ***Valuation matters***

1. Asset allocation approach which incorporates a Multi Asset platform

Academic research suggests that the decision to allocate assets among various asset classes will far outweigh security selection and other decisions that impact portfolio performance. The endowment funds in the US have a long history of multi-asset class investing and many have built up a very strong track record of returns. Foresthill Financial Planning Ltd (as a member of the Trusted Advisor Group) adopts an asset allocation policy which is influenced by the US endowment fund model. Despite difficulties for some of the high profile endowment funds during the credit crisis, investors can still learn a lot from these funds in terms of the application of multi asset class investing.

An investment approach based upon investment across multiple asset classes is not a proprietary strategy. It is an approach recommended the world over, but one which is followed with almost total indifference. In our view it is important to formalise the process and set down the principles so that we avoid this tendency for indifference.

2. Value principles

We feel skill and hard work can lead to a "knowledge advantage," and thus to potentially superior investment results. In so-called efficient markets large numbers of participants are

supposed to share roughly equal access to information and act in an unbiased fashion to incorporate that information into asset prices. We do not subscribe to this view. We believe less efficient markets exist where the application of skill and effort will eventually pay dividends to the investor. In these situations we believe in applying a robust investment strategy based on a sound and consistent investment process.

3. *Process over outcome/result - Long term investment process over short term results*

This process should be adhered to and not be hijacked by short-term trends or fashions. Investment is a profession which involves a combination of skill and luck. While luck plays a significant role, what we can measure in the short term may not be what matters in the long term. Ultimately, it is a good process that leads to good performance, accepting that process gets swamped in the short term by luck.

Clearly success is going to be measured by something observable and this will inevitably focus on results, but investors need to focus more on the process and how performance is generated. You can get lucky with investments via a bad process, but this is not a route to long term success.

4. Rebalancing on a regular but practical basis

Whilst it's not realistic for small retail investors to access the same assets as the large endowment funds, it is possible to adopt similar asset allocation principles. The ultimate goal of the endowments is to produce sufficient funds to provide scholarships, maintain libraries and museums, and to support teaching and research. The goal of the average investor (particularly pension investors) is not too dissimilar in terms of its goal of providing a pool of money from which to fund lifestyle & retirement activities.

The benefits that diversification provides goes hand in hand with rebalancing. Without rebalancing the total return will simply be the weighted average of the long term returns, providing no diversification benefit. Rebalancing benefits rise as volatility rises, so the greatest benefits come during periods (like 2008/2009) when there are wild movements in portfolios. Clearly, diversification does not assure a profit or protect against a loss, but it limits the damage inflicted by large downside events.

5. *Active management AND Passive management*

Despite the contention by promoters of passively managed funds that the majority of active managers do not beat the sectors ‘average’ performance standards, we still have faith in active management. While we do not dispute these facts, we feel the real question should be not how many active managers beat the ‘average’ but rather, how many are actually trying to do so! In ‘relative’ management analysis, the (self preserving) instinct is to stay with the ‘herd’. It may represent too much ‘career risk’ for an active manager to stray too far from the pack in investment management terms. Investment history is littered with stories of managers whose contrarian views got them sacked just before their convictions were proved correct. We seek out quality active managers who have the courage of their convictions and are willing to ‘swing the bat’.

All of this said there is still a place for passive management and the access it can offer to markets, sectors and certain investment themes. Where markets are well developed and display a high level of efficiency passive funds have a useful and cost effective role to play.

6. Applying overall philosophy at appropriate levels of risk for the particular individual

Superior investment performance is not our primary goal, but rather superior performance with less-than-commensurate risk. The emphasis at our firm is on consistency and protection and less on one-off high returns.

7. Valuation matters

While we believe that asset allocation is fundamental and we advocate a robust & clear long-term investment strategy with a long term view, we also realise that asset valuations are important. When investing a portfolio of assets, consideration should be given to the long-term valuation of any asset and this should have an influence on the specific asset mix chosen.

3. Risk Profiling

Clients' perception of 'risk' and what the financial services industry considers to be 'risk' can differ entirely. This can lead to confusion if we were to rely solely on quantitative measures of risk, such as 'volatility'.

Academics define investment "risk" as the volatility of returns, i.e. the extent to which the returns tend to fluctuate. The more volatile an asset the more in terms of a return we require to invest in it. The volatility number is simply an expression of the uncertainty about the size of changes in a funds value; Higher volatility - values can potentially be spread out over a larger range of values. Low volatility - value does not fluctuate dramatically.

Clients in our experience do not think of 'risk' in terms of narrow mathematical terms. Clients are primarily concerned about a loss of capital or paltry returns, not necessarily price fluctuation. Clearly we cannot ignore the volatility of returns, but risk preferences need to be assessed under a broader canvas than one which focuses mainly on volatility.

But just as risk is not a single number, neither is a client's risk profile. This is difficult to measure accurately. Our approach to risk profiling is to ask the client to fill out our risk questionnaire. The questionnaire should only provide a starting point for a conversation about investment risk, not an ending. We use the output of this tool to form the basis of a broad discussion on risk.

Risk profile questionnaire

A client's 'willingness' to take risk, as measured by a questionnaire for example, is only a small part of a client's full and true risk profile.

There are three key components which comprise an individual's overall risk profile. These are

1. Their actual **ability** to take risk, financially - called their 'risk capacity'
2. Their **willingness** to take risk - often called their 'risk attitude' and
3. Their **need** to accept or take on risk - which includes the need to accept risk to achieve an objective or goal.

Ability to take risk relates to financial circumstances and investment goals. Generally speaking, the higher the level of wealth relative to liabilities, and the longer the investment horizon, then the greater the ability to take risk.
Willingness, or 'risk attitude', on the other hand, relates to psychology, rather than to financial circumstances. Some individuals find the prospect of investment volatility and the

chance of losses distressing. Others are more relaxed about those issues. We try to fully understand the psychological willingness of each client to take risk. This is what risk profiling should focus on.
The **need** to take risk is the third component of a true client risk profile. Willingness and ability should to be evaluated in the context of an individual's need to take risk to achieve a goal. If they have a very low risk profile with a very demanding investment objective, something will have to give.

Risk Mis-match

Clients' psychological willingness to take risk can sometimes clash with their financial ability to do so. For example, a client might express a preference for risk which is low, but have a financial situation which indicates a risk capacity which is higher. When such a conflict exists, we need to take time to counsel the client and explain the consequences of the mismatch. We explain the consequences of low returns to more conservative investors with liquid wealth and vice versa.

Ultimately, a client might insist on an investment strategy that matches their risk attitude and we may need to accept this. But having had the conversation, the client/adviser decision will at least be in the context of a thorough review of the investor's risk capacity, attitude and need.

At FFP we have available to us a number of risk profiling tools. We currently favour the Oxford Risk Questionnaire, commissioned by Standard Life in the UK and one of only a few such tools endorsed by the UK Financial Services Authority (FSA)

Discussion on Risk

Using standard deviation as the measure of risk assumes that the risk of an investment is exactly the same for everyone, and that it should be measured in the same way. In reality we all perceive risks differently: what seems a risky investment to one person may seem quite acceptable to another.

Considering risk as a concept, rather than a simple number, we begin to get a better sense of what the pertinent issues are for making investment decisions. As such, here are issues on risk and return which FORESTHILL believe are important to the process of advising on investments.

As an investor's time horizon lengthens, the greatest risks are that: the investor's assumed rate of return is not met and/or the value of the investment is eroded by inflation.

Shortfall Risk

This refers to the risk of failing to meet a long term investment goal. This can arise for several reasons. If an investor didn't take on enough risk to generate the returns required. On the other hand, they could also be exposed to shortfall risk if they invest in too many high-risk assets causing their portfolio to lose value at the wrong time. This is a serious risk to consider. Clearly, certain assumptions about the future have to be made in terms of determining a strategy for reaching goals, which may turn out to be erroneous. But all clients have to go on is the historic experience of asset class returns.

The relationship between risks and rewards needs careful explanation to ensure that investors understand how we structure their portfolios. At FORESTHILL we use long term asset class returns to show varying scenarios for portfolios and articulate these to a client.

Inflation Risk

Inflation was described by Milton Friedman as the only tax to be introduced without legislation. It is like a stealth tax eating away at the value of money. One of the hardest things for most investors to accept, is that in a low inflation environment, a return of 6 or 7 per cent is an attractive option. Minimal inflation makes double digit returns a practical impossibility unless you go much further up the risk scale than you really want to be.

Whilst most clients understand they want to preserve wealth, we all have a natural tendency towards thinking about money in nominal terms, i.e. without factoring in the effects of inflation. Clients may not see a smaller cash balance in their accounts, but they will definitely lose buying power. In other words, the amount that they can purchase with each euro slowly erodes over time.

Investors need to understand that some savings vehicles fail to pay a return that beats inflation, especially after tax is deducted. The real purchasing power of their savings is what counts. It is important that our clients don't confuse certainty and security. The certainty of cash returns, does not provide security against inflation.

Inflation in the US over the very long term has averaged c. 3% p.a. Clients that ignore the risks posed by inflation, do so at their peril. 3% inflation reduces the purchasing power of a portfolio by one quarter over a ten year period.

Using data from Sarasin & Partners compendium of long term asset returns, it is possible to assess inflationary risks, by looking at the real returns (i.e. returns after stripping out the effects of inflation) of asset classes. What this shows is that based on rolling ten year periods, going back to 1900, the worst ten year period for both gilts and cash was considerably worse that the worst 10 year experience for equities when you take in to account inflation. So inflation risks are extremely important.

Drawdown Risk

In our experience, clients don't understand volatility and cannot relate to it. When we present figures showing what an investment's experience has been using drawdown, it tends to resonate much better.

The drawdown of a fund is the loss from the peak to the current value of a fund. Maximum drawdown is the maximum loss within a fund (over some specified period), from the peak to a trough.

4. Asset Allocation

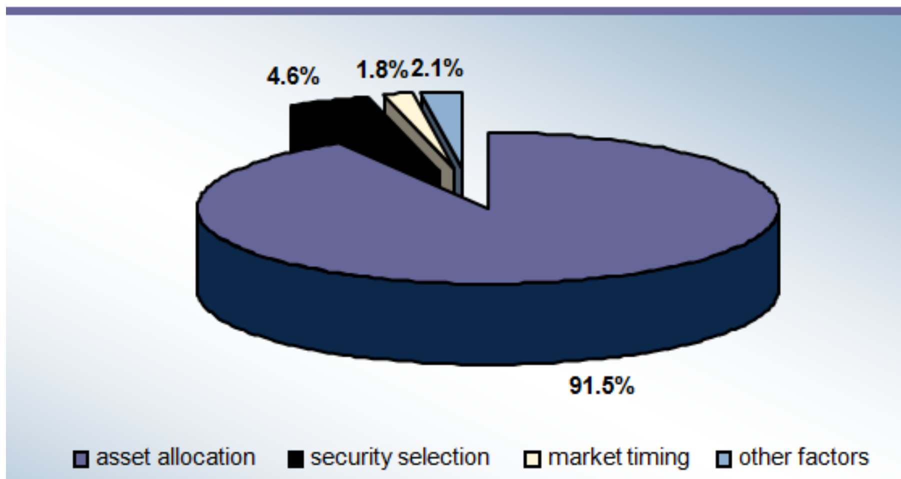
Having established what the client's objectives are and agreed an appropriate level of risk commensurate with the goals and attitudes, it is important to then translate this into an appropriate investment strategy.

Empirical studies demonstrate that the vast majority of investment returns can be attributed to the asset allocation decision. The results of these studies are often misinterpreted, but consistent through the analysis is the observation that active investment decisions such as market-timing and/or security selection have a more modest impact and, on average, reduce portfolio return. The studies of interest here are, Brinson, Singer, and Beebower (1991); Ibbotson and Kaplan (2000), and most recently, Vanguard (2003). All have confirmed these results using both pension and mutual funds during various times periods from 1962 through 2003.

Clearly, an investment approach based upon investment across multiple asset classes is not a proprietary strategy. It is an approach recommended the world over, but one which is followed with indifference.

The FORESTHILL Portfolios will maintain an active asset allocation strategy, as distinct from a tactical asset allocation strategy. The Portfolio will set out with a strategic allocation to a selection of diverse asset classes. No assessment is made about the likely short term performance of any of these asset classes and no short term changes (tactical) to the asset allocation will be made in an effort to add value. The portfolio will take advantage of the inevitable swings of capital markets to regularly rebalance however (see section on Rebalancing).

Factors Explaining Dynamics of Returns over Long Horizons



Source: Brinson, Singer and Beebower (1991)

ESMA (formerly CESR) Portfolio Models

In conjunction with a new common European standard, we have constructed portfolios based on the ESMA (European Securities & Markets Authority) risk ratings. This methodology uses a consistent measure of risk and reward. The general methodology for calculation of the Synthetic Risk and Reward Indicator (as ESMA terms it) SRRI is as follows:

1. The SRRI is based on the volatility of the fund.
2. Volatility shall be estimated using the weekly past returns of the fund, or if not available, the monthly returns.
3. The returns used in calculating the volatility shall be gathered from a sample period covering the last five years of the life of the fund. These shall be measured taking into account the relevant earnings or dividend payoffs.
4. The volatility of the fund is assigned into risk classes 1-7 as shown below. Therefore, for example, if a fund has volatility calculated between 0.5% and 2%, it falls into Risk Class 2.

	Volatility Intervals	
Risk Class	Equal or Above	Below
1	0%	0.5%
2	0.5%	2%
3	2%	5%
4	5%	10%
5	10%	15%
6	15%	25%
7	25%	

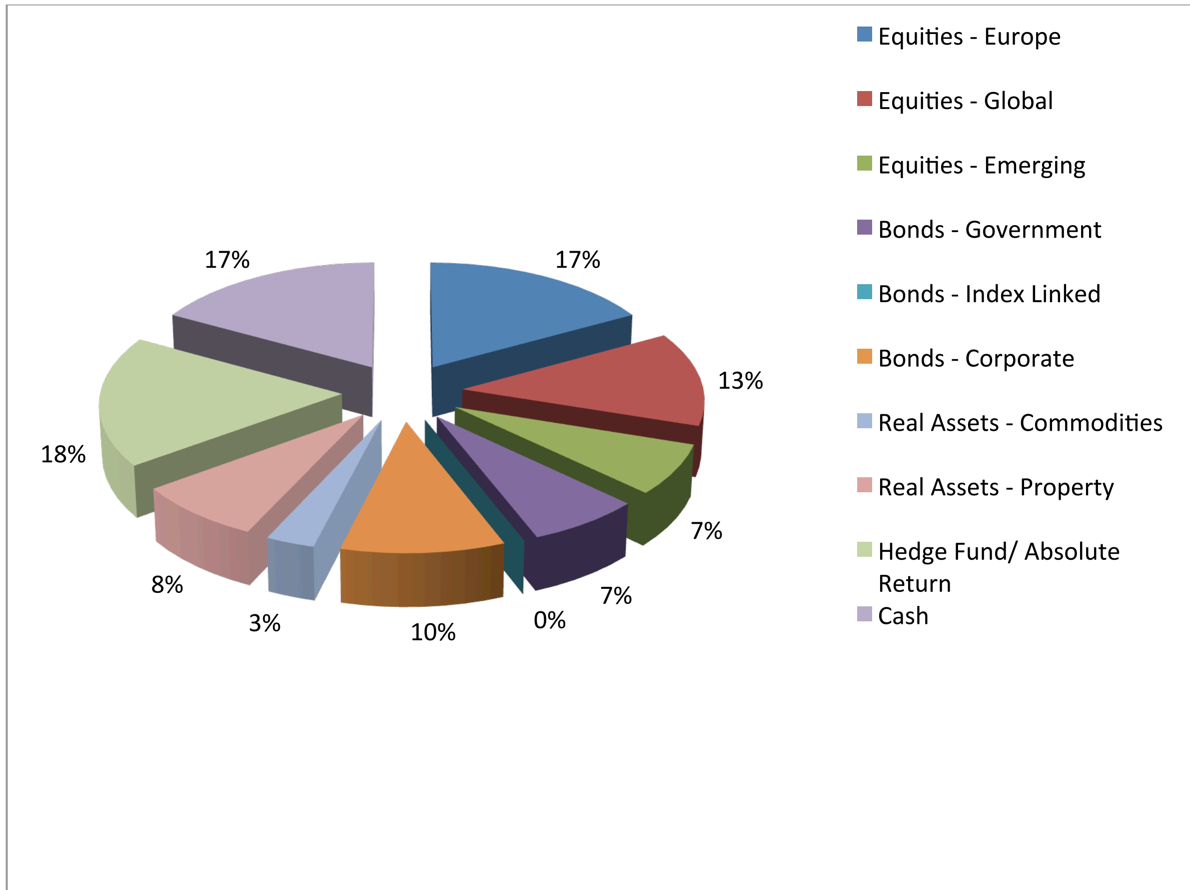
FORESTHILL Model Portfolios

Given the seven scales of risk, there are seven model portfolios which map on to each of these risk scores. The portfolios were constructed using five years of monthly data on asset class volatility and correlations. Each model has an asset allocation with a portfolio volatility around the middle of the range of that outlined in the above table. However at the lower end of the scale, the portfolios target a volatility at the upper end of the band to limit the impact of large scale jumps in risk between the categories from SRRI 3 upwards.
Over recent years we at Foresthill, in the absence of any common Irish or European Standards, have been very happy to follow asset mix of the large US Endowment Funds. these remain solid and robust asset mix templates which we will continue to by loyal to. On the ESME risk scale outlined above these model portfolios would be placed as follows;

TAG MAP Portfolio	***Risk Class***
Model Portfolio	5
Moderate Portfolio	4
Conservative Portfolio	2

A portfolio with a volatility score of 7.5% (i.e. risk model 4) would have the following asset allocation:

ESMA Synthetic Risk & Reward Indicator (SRRI)			
	Volatility Intervals		
Risk Class	Equal or Above	Below	
4	5%	10%	
Equities	Europe	17%	
	Global	13%	
	Emerging	7%	37%
Fixed Income	Government Bonds	7%	
	Index Linked		
	Corporate Bonds	10%	17%
Real Assets	Commodities	3%	
	Property	8%	11%
Absolute Return	Hedge Fund/ Absolute Return	18%	18%
Cash		17%	17%
			100%
Volatility Score		**7.58%**	


17%
17%
13%
18%
7%
8%
7%
3%
0%
10%
Equities - Europe
Equities - Global
Equities - Emerging
Bonds - Government
Bonds - Index Linked
Bonds - Corporate
Real Assets - Commodities
Real Assets - Property
Hedge Fund/ Absolute Return
Cash

5. Fund Selection Process

(i) Investment Philosophy & Fund Selection

The selection of appropriate investment vehicles within each asset class is a very important step in the investment process.

Much of what passes for brilliance in investing (with a few notable exceptions - Buffett, Soros etc) is a combination of luck and the ebb and flow of investment style. Consistent with our investment philosophy and in recognition of the inability of active managers to consistently outperform, we recommend investment through passive investments for a portion of a portfolio.
To be clear, we do not recommend passive funds on the basis of a belief in market efficiency. Capital markets are not efficient in the Efficient Markets Hypothesis sense. As such, we recognise the efficacy of an active approach to fund management also. We always seek out quality active managers who have the courage of their convictions and are willing to 'swing the bat'.

All of this said there is still a place for passive management and the access it can offer to markets, sectors and certain investment themes. In less efficient areas of the market, or where a viable passive alternative does not exist (e.g. absolute return, property), then active management is considered appropriate. Where markets are well developed and display a high level of efficiency passive funds have a useful and cost effective role to play.

Our approach to fund selection in this regard is outlined in section (ii) below.

(ii) Risk adjusted performance analysis

The separation of the lucky from the skilful in active management is achieved through a rigorous selection process for funds. It is not served by simple analysis of past performance. What we are looking for with a fund is a strong track record which has been achieved without excessive risk taking and which is repeatable. It requires a thorough analysis of many other factors including, though not limited to, the following:

- Risk adjusted performance track record
- Investment team
- Investment philosophy and process
- Risk controls and compliance/ governance structures
- Charges

On a quarterly basis we access a comprehensive report on all funds which provides a quantitative assessment of the best funds across each of the asset class categories. The analysis uses a range of risk adjusted performance metrics (Sharpe ratio, Sortino ratio, information ratio, drawdowns and volatility) to identify the funds which have achieved the best returns while taking account of the risk taken. Qualitative factors are important also, and we overlay a subjective assessment of the fund manager (in terms of style, team, investment process) on top of the quantitative analysis.

NB: In the situation in which a Fund does not have a sufficiently long track record to qualify for the quantitative analysis report (minimum three year track record), all of the emphasis will be on the qualitative aspects of the fund using the criteria mentioned above. Any assumptions about return will be very conservative.

6. Portfolio Monitoring & Re-Balancing

The ability to harvest gains as investments are going up, and at the same time invest in asset classes as they are out of favour is a very valuable discipline. Many investors fail to benefit from diversification, owing to a lack of discipline with respect to re-balancing.

Rebalancing Within Asset Classes

The so-called free lunch that diversification provides goes hand in hand with rebalancing. Without rebalancing the total return will simply be the weighted average of the long term returns, providing no diversification benefit. Rebalancing benefits rise as volatility rises, so the greatest benefits come during periods like 2008/2009 when there are wild movements in portfolio's. Clearly, diversification does not assure a profit or protect against a loss, but it limits the damage inflicted by large downside events.

Rebalancing Procedures

The benefits that diversification provides goes hand in hand with rebalancing. Without rebalancing the total return will simply be the weighted average of the long term returns, providing no diversification benefit. Rebalancing benefits rise as volatility rises, so the greatest benefits come during periods (like 2008/2009) when there are wild movements in portfolios. Clearly, diversification does not assure a profit or protect against a loss, but it limits the damage inflicted by large downside events.

The benefits of rebalancing can only be achieved by actually implementing a rebalancing strategy. To remain consistent with the asset allocation guidelines established by the FORESTHILL Model Portfolios, each fund in which the Portfolio invests will typically be reviewed on a yearly basis and rebalanced back to the normal weighting. The frequency of the rebalancing strategy can be increased by creating boundaries which trigger automatic rebalancing. For example, if the actual weighting varies by 15% (relative) or more from the recommended weighting, this should trigger a rebalance. This is referred to as parameter based rebalancing. This is agreed on a case by case basis.

Benefits of Rebalancing

One of the fundamental rationales for multiple asset class investing is a recognition of the difficulties in attempting to engage in tactical asset allocation (TAA), i.e. trying to time the allocation of assets based on likely near term prospects. Market professionals have demonstrated an inability to engage in successful TAA in adding value to portfolios. The triumph of hope over experience explains Investors persistence in engaging in this activity.

Clearly there are good and bad times to invest in equities. This is always obvious in hindsight, though never clear in prospect. If a client maintains discipline and regularly rebalances the portfolio, the benefits of TAA can accrue to them without having to consciously engage in it.

Rebalancing of Fund Selection

The quarterly risk adjusted performance report will inevitably identify funds which had a good track record for the period under review, but which subsequently disappoint. This is not an automatic trigger for a fund switch or sale. We will engage in a period of qualitative review of the fund, in order to establish the reasons for underperformance. If the underperformance is deemed to be as result of temporary factors we will continue to keep the fund on our recommended list. If there has been some material change to the fund or fund manager which undermines the investment case, then we will look to replace the fund.

If a fund switch is recommended, this will only be done if there is an appropriate fund available to switch into and the charges for making such a switch are not prohibitive for the client.

A re-balancing meeting for the funds should not, apart from exceptional circumstances, take place more frequently than once a year to avoid obsessing over short term fund performance.

7. Investment Reporting & Communications

Cognitively we get smarter through the generations, but not emotionally. Investment decision making is inevitably an emotional process. Learning to master emotions is one of the most valuable things that investors can learn to do.

It is our job as financial adviser, to use our experience of investor behaviour to coach our clients in achieving better results than they would without a professional adviser.

Left alone, investors often make choices that impair their returns and jeopardise their ability to fund their long term objectives. Many are influenced by market performance. This is often evident in market cash flows mirroring what appears to be an emotional response – fear or greed – rather than a rational one. Investors also can be moved to act by fund advertisements that feature recent outperformance – as if the investor could somehow inherit those historical returns despite disclaimers stating that past performance is no guarantee of future returns. This performance-chasing behaviour can seriously harm a client's long-term returns.

One approach to encouraging restraint is to have a formal, written investment policy or allocation guidelines for the entire portfolio. An investment policy statement helps investors commit to a disciplined investment plan so that their decisions are less likely to be swayed by emotion. We draft an individual IPS for every client of this firm. This is the blueprint for how the portfolio should be managed.

One critical thing to coach clients about relates to performance and the frequency with which they should monitor it. Short term results may not be in our clients' interest. We can achieve better long term results if we educate our clients to focus on the real risks of investment.

Performance Monitoring

Stock markets contain far too much short term 'noise' making any assessment of performance over short time periods meaningless. Quarterly performance reviews are more likely to lead to poor decisions than prudent ones.

How frequently you monitor your portfolio's performance can bias your perception of it. Suppose you were investing over a 5-year investment horizon in a high-risk equity portfolio.

Data from the US shows how you would perceive the portfolio depending on the monitoring period.

	Monitoring Frequency	
Percentage of time seeing	**5 Year Time Horizon**	**One Month Time Horizon**
Gains	90%	38%
Losses	10%	62%

Source: Aspects of Investor Psychology, Kahneman and Riepe, 1998.

Consider the table above. Over the minimum 5-year time frame, equity performance has been positive 90% of the time, and so risky investments do not lose money more than 10% of the

time. However, if you were to monitor the performance of the same portfolio on a month-by-month basis, you would observe a loss 38% of the time.

Monitoring a portfolio more frequently will cause clients to observe more periods of loss, and owing to an inherent sense of loss aversion, very likely to cause emotional stress resulting in them taking on less risk than may be appropriate for their long-term investment objectives.

Worse still is the danger that clients attempt to time markets based on emotion or sentiment. The empirical results here are simply appalling.

In short, if our clients understand the nature of compounding money, understand the dangers of a short term focus, and are presented with a best, worst and average scenario for their portfolio, their expectations for return should be sufficiently calibrated.

<u>Calibrating Clients' Return Expectations</u>

We have referred to the emotional challenges that investing poses throughout this document. This impediment to investment success is greater than any other. The temptation to abandon well thought-out but disappointing strategies moments before they work, in order to chase successful strategies just as they are about to run their course, can be overwhelming. How do we avoid this peril ourselves?

First, remember that economies grow at roughly 3% p.a. in real terms over the long term. Expectations for double digit returns are therefore an exercise in hope over experience. This is a seemingly obvious error, but one that is often made.

Secondly, it doesn't really matter how well you do in good times; over the course of many years it is how you fare in the hard times that will determine success. Consider the case of two investments; the first, earning 10% a year for ten years running. The second, much more exciting fund makes 20% a year in seven years, and loses twenty percent in three years (the chronology of returns makes no difference). The mind's eye pictures the high return fund as producing a return higher than the 'low' return fund. In fact, the first fund's return is almost double that of the second one.

The second fund is much more likely to attract assets, as it has had bragging rights for 70% of the time. We all seek investment returns which are above average, but the route to good performance as Howard Marks from Oaktree puts it, "is through consistency and protection, not single year greatness".

The obsession with short term results is a counter-productive

At FORESTHILL our focus is on educating our clients about the nature of compounding money. We are seeking consistency and protection for our clients. Our investment process aims to deliver good outcomes. A good process clearly does not guarantee success, but stacks the odds in our clients' favour. This is as much as we can hope for.

Appendices

Why are markets inefficient? – Behavioural traps investors should try and avoid

"Investing is an art not a science"!! If investing were a science then there would simply be a formula for success. Our successes (and failures!) are strongly affected by uncontrollable issues which emotionally affect us and cloud our judgement. These influences are many. Things such as random events, investor sentiment, market momentum and of course, plain, simple luck all have an unpredictable and inconsistent influence on markets. Analysts are always trying to rationalize these issues, define them and ultimately predict their timing and influence. This is of course nigh on impossible.

A massive ingredient in investor success is our emotional response to all these factors and how they influence our decision making. Our ultimate decisions are often based more on our emotional response than on logic or investment nous.

Successful investors and investment managers detail their investment strategy and put processes in place to help limit the effect of these 'emotional' influences or pitfalls. These pitfalls are well documented but it is worthwhile reminding ourselves what they are and how we might manage their effects. In reality, what gets people into trouble in investing is their temperament, making the wrong decisions at the wrong times. It is not a question of being smarter or less smart. What happens is that the emotions take over. Here are some of the major ones as defined in theoretical 'market-speak'.

Loss aversion – we hate to lose!

The fact is that losses hurt us something like two times more than gains give us pleasure!
In practical terms, this means that people are unwilling to convert an unrealized loss into a realized loss. People hang on to losers and watch them go down and down. They hope they recover somewhat so they can then sell them. This is very understandable. It's how our brains are wired. It's hard to lose money. It's hard to admit that you were wrong and 'chin' your loss and move on!! For this reason we all tend to hold on to our losers much too long.

Possible remedy
A possible way to overcome this is look into the future and not the past. This is difficult – more difficult than it sounds. The stockmarket doesn't care what's happened in the past. All that matters is what will that stock/share/fund/asset will earn in the future! What they have done in the recent past is almost irrelevant.
So that's what investors need to be thinking about going forward. If an investment stands at a loss, but the original investment strategy is sound, then you should stick to your guns. However, if you have a loss and the 'investment' situation or the stock/company has fundamentally changed, or the fund manager has gone off the rails, or the market or sector has altered, then the future has changed; but it's the future that's changed. It has little to do with what the share /stock's returns have been in the past.

Recency Bias – we have short memories!

In investment speak…people tend to overweight the most recent information. This simply means that people have short memories! They are much more aware of what has just happened compared to events further back in the past! So the most recent information carries more weight or influence than it should. This contributes to the well known situation where small private investors wait to see markets perform and gather up the good news before they invest (and therefore miss a great deal of the recovery/rise). They also lose their nerve when markets go down and news gets bad – they sell off and accentuate their losses. Emotional reactions!

Possible remedy
One way to combat this effect is to just look over the long-term. Stock market returns have been 5%- 7% over the long term. That's a much more relevant number than whether earnings were down 15% last year or up 20% last year.

Social proof – we like to conform!

Humans are wired to be social animals. We take comfort in the crowd. We always have and always will. Maybe we are wired that way for survival purposes, going back hundreds and thousands of years?
This can get us into a lot of trouble. Just because the crowd is doing something doesn't mean it's right. It doesn't means it's wrong, but it certainly doesn't mean it's right. Allied to this the media can often reinforce things – because what sells magazines and ads on the telly is what's popular. So the media tends to talk about what's in favour, not what's not in favour.

Possible remedy
So, investors must be mindful that just because everybody else is doing it, doesn't mean it's the right decision. It's not relevant. It's your money. It's the stock or fund that you own. Own it for the right reasons, not because it's in vogue!

Endowment effect – we overvalue what we own!

This is where investors overvalue what they already own – sometimes know as "falling in love with your own stocks!" It might be a share or fund that has done well for you over many years, but is stagnating for whatever reason now. You may be reluctant to let it go. It's because you're not evaluating things on a level playing field. Nowhere is this effect more obvious than in peoples 'opinions' of what their own house (or property) is worth!!….compared to the neighbours house or the exact same property around the corner!!
Investors should always evaluate shares or funds on a level playing pitch, whether they own the share/fund or not. The ownership is not relevant. All that matters is – "how will it perform in the future?" So, again, it's very hard to do. Saying that "this fund has made me lots of money" or "this manager has done really well in the past six or seven years" is pointless. These points are not relevant.

Possible remedy
Investors must consider what the future offers compared to what other options they have? – The Opportunity cost?? If they think this stock/fund will continue to grow at a 3%-4% rate, but other options can give 6 or 8% then they have to make the hard call. So, evaluating other alternatives always makes sense.

Confirmation bias – we like to think we are right!

It is a fact that we process information that we already agree with more easily. We hang out with people who think like us. And in investing, that means if we feel good about the market, we probably read a bullish investor. If not, then the opposite is likely – we will agree with and therefore read the pessimistic commentator/analyst.

Possible remedy
To combat this people need to read varied opinions, listen to individuals and consciously seek out individuals and points-of-view that are contrary to theirs. This won't be easy to stomach because these people's views are disagreeing with them. They are actually telling them that they think they could be wrong! This is not what any of us want to hear … but …. this can be really valuable information to know.
So, trust your own opinions, but verify them. Verify them by actively seeking out people with the other point of view, and then testing your own beliefs. You might wind up sticking to your guns or you might come across information you wouldn't have otherwise found that will help you make a better decision.

Career Risk – who wants to lose their job?

This is an emotion or experience that is more relevant to a fund manager than to a private investor. It is generally portfolio/fund/stockbroking managers who might suffer from what is called career risk.
If you're a portfolio manager in a Life, Pension or Stockbroking House, your performance versus the benchmark and your peers is being tracked weekly if not daily! You underperform for a couple of weeks, or you have a bad quarter then you are going to soon start to feel the heat. You are going to feel pressure if you stand out from the crowd or if you have gone on a solo-run in terms of investment decisions. You may even feel that your job or career will be threatened if your performance compares badly with the so-called benchmark or 'herd'. Investment history is littered with stories of managers who called things correctly, only to lose their nerve (or their jobs) shortly before their contrarian predictions came true! Obviously, as an individual investor, you can't fire yourself. You have no career risk in that sense. So, hopefully, you can think a little more rationally.

Again, in summary, investors should do their best to avoid these emotional traps. They need to have an investment philosophy. From it, they need to develop an investment strategy. Then they need to devise an investment plan… and then stick to it, while reviewing its validity at predetermined intervals.