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WEALTH MANAGEMENT

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Monthly Insight

Behavioral Finance: Lessons from March Madness

We have just emerged from the annual phenomenon known as "March Madness": the time of year when sports fans in general—and basketball fans in particular—become obsessed with the NCAA tournaments, with their carefully chosen brackets, and especially with the prospects for their favorite team to successfully navigate the competition to take a place in the Sweet Sixteen, the Elite Eight, the

Final Four and—if fortune truly smiles—to be crowned as the champion of collegiate basketball.

As we now know, the men's title was claimed by Virginia this year. This was especially gratifying to Cavalier fans after last year's humiliating loss in the first round to the #16-seeded University of Maryland–Baltimore County Retrievers. That was the first time in NCAA tournament history that a #1 seed was defeated in the first round by a #16 seed. But this year, the Cavaliers redeemed that embarrassing defeat, capping the effort with a thrilling 85–77 overtime victory over the scrappy Red Raiders of Texas Tech.

Curiously, however, though Virginia went into the tournament again this year as a top seed and a leader in several important statistical categories, very few of the bracket-pickers initially chose them to win the tournament. In fact, slightly less than 6% of submitted brackets had Virginia picked as the champion. Overwhelmingly, the handicappers went for Duke (39%). Even North Carolina, seeded below Virginia, received more than twice as many winning picks as the eventual champion.

What does this have to do with investing? Well, it illustrates a couple of the traits that commonly cause investors to make poor decisions: recency bias and confirmation bias. Because of the way our nervous and behavioral systems evolved, human beings tend to place greater trust in more recent information and to give less heed or credence to "old news." We also tend to ignore information that contradicts a belief we already hold. Thus, a majority of bracket-pickers had vivid memories of Virginia's failure in the 2018 tournament. This recent experience, coupled with their perceptions of Virginia as a primarily defensive team and their belief that a defensive team couldn't win the national tournament, persuaded them to ignore other information that might have contradicted what they already "knew." Similarly, in investing, many are highly attuned to the "latest" darling stock or

mutual fund, the “hot” sector, or the market chatter currently getting the most headlines. At the same time, if we are convinced that “the market is oversold” or “this market has nowhere to go but up,” we tend to be skeptical of data or other information that doesn’t confirm what we already believe.

The problem, of course, is that our gut instincts, intuition, or whatever other term you might apply to emotionally based decision making, did not evolve for the purpose of making sound decisions about something as complex, interrelated, vast, and rapidly changing as the modern financial markets. These markets are driven by literally millions of individual buying and selling decisions made every minute, all over the world. When you consider this, it seems impossible to believe, as some apparently still do, that any individual can know what the market is going to do during any particular day, month, or year. And yet, investors continue to allow behaviors driven by emotion and incomplete data to govern their decisions.

An example from recent history illustrates this tendency in action. From roughly 2003 to 2007, emerging markets were the hot asset class to own. The sector was turning in better market performance, as a whole, than US equities and also outperforming most other mature markets. In fact, from 2000 to 2009, the S&P 500 recorded its worst-ever 10-year cumulative return (-9.1%). During the same period, the MSCI World Ex-USA Index managed a return of 17.5%. As is typical, investors began to jump on the band wagon, and cash inflows into individual equities and equity funds focused on emerging markets around the world ballooned. What happened next was predictable: beginning in about 2012–13, the growth rate in emerging market began to cool off. In four of the last six years, investors have seen laggard returns from the portion of their portfolios devoted to emerging markets when compared with other sectors. Consequently, many investors have lost confidence in what was previously viewed as the “must-have” sector. When all the recent information pointed to the

outperformance of emerging markets, the crowd wanted in. Over time, as emerging markets continued to do what all markets do—fluctuate in cyclical patterns—recency bias began to contra-indicate the wisdom of investing in emerging markets, and restless investors began to search elsewhere—many likely following the latest headlines in whatever direction their confirmation bias led them.

The 2018 Market Review from Dimensional Funds, Inc., looking back at the period 2000–2009 in emerging markets, makes this observation: "In periods such as this, investors were rewarded for holding a globally diversified portfolio… Maintaining discipline to these parts of the market is the key to effectively pursuing the long-term returns associated with size, value, and profitability."

Were investors wrong to get into the emerging markets sector in the first place? No. Were they wrong to get out, or to allocate at least a portion of their holdings in other ways? No again. The problem is not holding one investment or the other; the problem is failing to go into the investment with an understanding of the fundamentally cyclical nature of all markets, coupled with a commitment to a disciplined plan for diversification that fits your risk tolerance and your investment objectives.

One of the major components of our work with clients is to help them understand the risk inherent in all asset classes. It is impossible to remove risk from the equation, no matter what type of asset is under consideration. But it is possible to mitigate various risks by establishing proper diversification among various asset classes, by rebalancing the portfolio when appropriate, and by basing financial decisions on scientifically tested, market-proven principles, rather than relying on hunches, headlines, gut instincts, or other emotionally-driven methods.

If you are interested in ways to take guesswork and emotional

overreaction out of your investment portfolio, we would love to talk with you. We can discuss your particular financial objectives and help you develop a sound, research-based strategy for meeting them.

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President, CFP®, CPWA®

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