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WEALTH MANAGEMENT

Monthly Insight

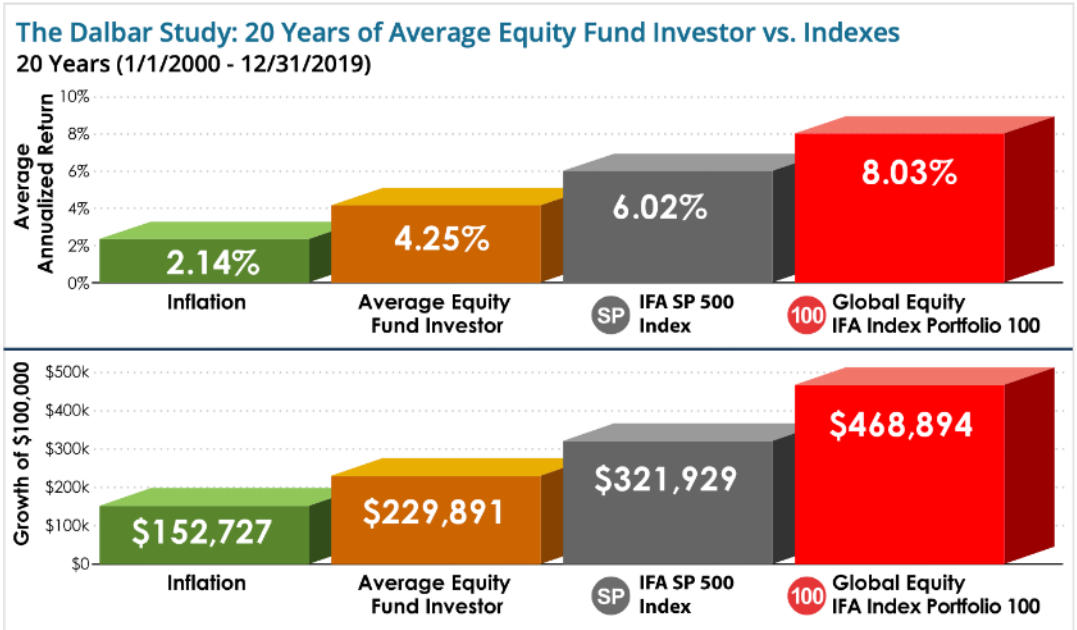
Taming Your Emotions: The Key to Better Investment Returns

One of the most frequent pieces of advice that I offer to clients—especially in volatile markets—is the caution against making decisions based on emotion. This was abundantly clear in the spring of this year, when we saw markets dive on news of the novel coronavirus and the worldwide economic shutdown imposed to slow the spread of the disease. There were many days when watching the major market indices felt like being strapped into a runaway rollercoaster, complete with stomach-churning drops, dizzying climbs, and then more freefall. It was an unprecedented time in the markets, and it's easy to understand why investors felt uneasy as they watched the value of their portfolios fall, some by more than 30%.

Since then, as we know, though they haven't regained the heights of early February, markets have recovered most of the losses racked up during the dizzying days of March and April. Investors who were able to manage their emotions and remain committed to a disciplined strategy have generally fared well. On the other hand, those who succumbed to panic and sold out during the downdraft have either watched helplessly from the sidelines as their former holdings regained value or have been drawn into a frustrating attempt to play catch-up, with little likelihood of recovering the growth they forfeited by jumping ship.

Why are investors prone to emotional behaviors that ultimately work against their long-term best interests? Certainly, we can blame a lot of it on the fact that the human nervous system is hard-wired to avoid perceived danger. This was a lifesaving attribute when we lived as hunter-gatherers, but in the modern, computerized financial markets, the instinct to flee is typically unhelpful for improving portfolio performance. It's also nothing new.

For 36 years, the independent investment research firm Dalbar, Inc. has been compiling statistics on individual investor behavior and its effect on portfolio value. Their annual report, "Quantitative Analysis of Investor Behavior" (QAIB), tracks the performance of individual investors in mutual funds, comparing their returns with major index funds. According to the QAIB, over the twenty years from January 1, 2000, to December 31, 2019, the average individual investing in equity funds has achieved a growth rate of 4.25%, or 2.11% better than inflation. During the same period, a benchmark S&P 500 index fund returned 6.02%, and a benchmark global equity index fund returned 8.03%. Another way of viewing it is that the average investor was able to turn $100,000 into $229,891 during the period, while the S&P 500 fund returned $321,929, and the global equity index fund returned $468,894.



* Average Equity Investor as determined by Dalbar | Study sources, Dalbar 2020 QAIB Study, Morningstar, Inc. | For HYPOTHETICAL back-tested performance data shown in this chart, including sources, updates and important disclosures, see ifabt.com IFA Index Portfolios are labeled with numbers that refer to the percentage of stock indexes in the asset allocation, as opposed to the allocation of bond indexes. For example, an IFA Index Portfolio 90 is 90% IFA stock indexes and 10% IFA bond indexes. IFA Indexes are labeled with letters to designate the index name and are defined at indexdescriptions.com. HYPOTHETICAL back-tested performance of IFA Index Portfolios assumes annual rebalancing of the asset allocation of the components comprising the IFA Index Portfolios. The HYPOTHETICAL back-tested performance of the IFA Indexes and IFA Index Portfolios was achieved with the benefit of hindsight; it does not represent actual investment strategies for the entire period; and it does not reflect the impact that economic and market factors may have had on the advisor's decision making if the advisor were actually managing client money during the period shown. The performance of index portfolios does reflect the deduction of a 0.9% annual investment advisory fee, which is the maximum advisory fee charged by IFA, and mutual fund fees associated with the management of an actual portfolio over the entire period. Unless indicated otherwise, the performance of the IFA Indexes when shown individually, does reflect the deduction of mutual fund fees, include reinvestment of dividends and capital gains but does not include the deduction of IFA advisory fees, transaction costs or taxes, which if included, would lower performance. The IFA Indexes and IFA Index Portfolios were created by IFA in 2000. Past performance does not guarantee future results. Data is provided for illustrative purposes only, it does not represent actual performance of any client portfolio or account and it should not be interpreted as an indication of such performance. © 2020 Index Fund Advisors, Inc. (IFA.com)

What's the difference? Just this: individual investors in mutual funds tend to make more imprudent decisions that penalize long-term growth. The Dalbar, Inc. study suggests that the performance of an individual investor's mutual fund portfolio is far more likely to be affected by the investor's behavior than by the fund manager's performance. Simply put, many investors are their own worst enemy. By trying to time the market or chase performance, they undermine their ability to take advantage of long-term market trends that would otherwise work in their favor.

How can you keep your portfolio from falling victim to your emotions? Researchers in behavioral finance offer several suggestions for "taming your inner bear," starting with recognizing the behavioral biases that are prone to affect your financial judgment.

The first—and perhaps most prevalent during a volatile downturn like the one we saw last March and April—is *recency bias*. This behavioral trait causes us to put more weight on what is happening right now than what happened in the past or might happen in the future. When the market is dropping, for example, recency bias causes investors to see only the falling prices and to place little importance on other factors, such as the historical upward trend of equity prices or even the value of equities five or ten years ago. The antidote for recency bias, of course, is in taking a longer-term perspective regarding both historical factors and future likelihoods. An investor who was able, during March and April of this year, to remember that her portfolio had previously enjoyed good growth, had recovered from down markets in the past, and was positioned for growth in the future would have been less likely to become panicked because of the market's recent behavior.

Another behavioral trait that works against investor psychology is *pattern bias*. This is a tricky one, since the ability to recognize patterns helped our ancient ancestors capture game, find water, and avoid natural disasters. But in the financial markets, patterns can often be more apparent than real, and even the experts misread them with surprising frequency. However, when we detect what we believe is a pattern, our brains are predisposed to place great faith in this information and to act accordingly. Unfortunately for pattern-seekers, the exact direction or amount of price movement in any particular equity or even group of equities during a given time period is impossible to predict with any statistical significance. The better course is to give more attention to long-term trends and a broad spectrum of asset types. Rather than trying to spot "the winner," wise investors allocate their assets in a well-diversified manner, knowing that at any given time, one type of asset may outperform others.

A third common behavioral bias is the *herd mentality bias*. This trait, as the name implies, encourages us to imitate the behaviors of the majority. If "everyone" is buying a certain stock or type of stocks, the herd mentality pressures us to do likewise. If "everyone" is selling their equity holdings, we feel we should do the same. As you may remember from your adolescent years, the herd mentality can be a strong influence. When our parents said things like, "If all your friends jumped off a cliff, would you do it, too?" they were warning us against the dangers implicit in herd mentality bias. For investors, one of the best protections against this behavioral impulse is access to solid, evidence-based advice and peer-reviewed research. When your investment decisions are grounded in logic, research, and facts—instead of "the wisdom of the crowd"—your chances of success are much higher.

One of the most valuable services I offer my clients is access to just this type of research and advice. As a professional, fiduciary advisor, I am duty-bound to place your needs first. For that reason, my process begins with learning everything I can about your unique goals, your tolerance for risk, and the resources at your disposal. From there, I can help you craft a plan designed to help you achieve your long-term financial goals. I'll be there with you, every step of the way—in both rising and falling markets—to provide a professional "guard rail" against the emotional reactions that can pull you off the road to financial security. If I can answer a question or be helpful in some other way, please get in touch with me.

Stay Diversified, Stay YOUR Course!

KIMBERLY FOSS

President, CFP®, CPWA®, CFT-I™ Candidate

"We understand that every person we serve has distinct values and ambitions, and they each need their own plan for wealth management."