Ideas About Investing

A Quest for Investment Enlightenment
December 31, 2016

Why is it that investors consistently do worse than the market averages among a wide variety of asset classes over long periods of time? In their most recent *Guide to the Markets* U.S. 1Q 2017, JP Morgan Asset Management provides 20-year annualized returns by asset classes (1996-2015) that shows consistent average investor underperformance versus REIT's, the S&P 500, a 60/40 and 40/60 allocation between Stocks and Bonds, 100% Bonds , Gold, Homes, Oil, etc. In not a single case do average investors match the annualized returns of these different asset classes. For example, the S&P 500 returned 8.2% annually, a 60/40 stock bond allocation returned 7.2% and the average investor's return was only 2.1% over that 20 year period.[1]

Much of the underperformance can be explained by poor market timing decisions. Missing the best days of market performance dramatically impacts long term performance. For example, between January 1996 and December 2015, the S&P 500 was up 8.18% annually. But if you missed the best 10 days over that time period the returns dropped to 4.49%. Missing the best 20 days lowered the return to 2.05% and so on. But this is not new news. Charts showing this data are now a staple of investment marketing presentations. So why in spite of this overwhelming well publicized evidence, do so many investors think they can successfully time the market?

A new book by Michael Lewis, *The Undoing Project*, sheds light on this subject. The book tells the story behind the Nobel Prize winning work of two Israeli psychologists who demonstrated how the unconscious biases people bring to decision making cause them to make systematic errors of judgement when dealing with uncertainty. Their work was the foundation for the field of behavioral economics and provides great insights about why the public keeps making the same mistakes when they should know better. Among their conclusions:

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[1] Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc. Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz., Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31 /15 to match Dalbar's most recent analysis. Guide to the Markets - U.S. Data are as of December 31, 2016.

- People tend to underestimate uncertainty, but after the fact create a story to explain how what happened was predicable in hindsight. The handwriting was on the wall but the ink was invisible.
- People have hindsight bias and misremember their predictions as being correct. After the fact they explain what happened with a great deal of confidence. It leads them to believe that there is a less uncertain world than there actually is. People predict very little and explain everything.
- People believe they can predict the future if they work hard enough.
- People accept any explanation as long as it fits the facts.
- People make decisions not to maximize utility but to minimize regret. The anticipation of regret affects decisions and they will pay dearly for certainty.
- Last impressions can be lasting impressions.[2]

How do these conclusions apply to investment decisions?

Think about how the market's crash in 2008/9 has impacted investor behavior. After the fact many people looked back and in hindsight said "the handwriting was on the wall" and regretted having too much money invested in the stock market. A common response was to sell some or all of their stock market holdings at the worst possible time, paying dearly for "safety".

More recently there were two periods of extreme uncertainty in the stock market this year, the Brexit vote in the U.K. in late June, and the U.S. Presidential election. If you had the results of the votes beforehand, would you have been positioned in your investments correctly? It's highly unlikely. Most experts predicted that Brexit would lose in a close election and that Donald Trump would not only lose but the margin of his loss could be historic. In the unlikely event that the experts were wrong, the experts also predicted that the unexpected results would be terrible for the stock market. Well, Brexit won and Donald Trump was elected and the markets defied the expert opinions and rallied dramatically to new highs.

The truth is, knowing the outcome in advance would not have helped, and in fact is more likely to have hurt your performance by causing you to raise cash, exactly the wrong thing to do. Recognizing our inability to predict the future is paramount to better decision making. Emotions can play havoc with our ability to make rational decisions.

So how can the average investor protect themselves from the biases we all bring to investment decision making and increase the odds of better investment performance?

- Review your goals and construct an asset allocation that will get you on a path to meeting your objective. Then stick to the plan. It makes sense to adjust an allocation to asset

[2] Michael Lewis, *The Undoing Project*, Page 197.

classes when they deviate outside agreed upon ranges but this should be done infrequently to minimize transaction costs and capital gains.

- Do not have more money in the market than you are comfortable investing to avoid panicked selling during market declines. Declines should be opportunities to buy from panicked sellers with the cash reserves you have for that purpose.
- We are cautiously optimistic in our outlook but always prefer looking at asset allocations at times of strength. With the stock market at new highs we believe this is an opportune time to review your overall financial plan and your current asset allocation. Please call us if we can be of assistance.