An Expensive Lesson in History

On March 24, 2000 the S&P 500 peaked at 1,552.87 after experiencing a tremendous 12+ year bull run. In fact, the index appreciated 582.1% coming off of the market low on December 4th, 1987. By early 2000, the tech bubble found itself on unstable ground as stock valuations surged to unsustainable levels. Unfortunately, investors were largely focused on the returns US large cap stocks had produced over this time period, so much so that they continued to pile into these stocks despite the dangerously high valuation levels. Overall, $261 Billion flowed into domestic mutual funds in the year 2000, according to the Investment Company Institute. Subsequently, the S&P 500 achieved a cumulative negative return of (31.3%) over the two year period of December 2000 to December 2002. This negative return meant a $1MM investment during that time would have declined to $687,000. To recover from a loss that big, the portfolio would have to increase 45.6% just to get back to even.

Emotion Yields Poor Results in Investing

A study conducted by DALBAR, Inc., an independent firm specializing in evaluating and auditing investment companies, provides an analysis of the results mutual fund investors have achieved relative to stock and bond indices. The results are astounding. Over a 20-year period ending in 2010, the S&P 500 average annual return was 9.14%/year. The average equity investor in mutual funds achieved an annual return of only 3.83%/year.

In fixed income, the Barclay’s Aggregate Bond index returned 6.89%/year over the past 20 years.

However, a fixed income mutual fund investor only achieved a return of 1.01%/year. The differences are largely attributed to market timing mistakes based on behavioral biases (DALBAR, Inc.)**. Had these investors not given in to these behavioral miss-steps, it is likely that they may have seen an increase in their overall return.

When market conditions generate extreme levels of optimism or pessimism, behavioral market timing mistakes are usually amplified. In the investment world, the standard compliance tagline is “Past performance may not be indicative of future results”, yet past performance continues to drive investor behavior. Investor confidence tends to rise after stocks do well, reinforcing the behavior to buy stocks when they are expensive. Similar behavioral forces work in the other direction. Investors are averse to experience losses and have a tendency to sell stocks soon after they decline in value and are actually cheap.
An extreme behavior in selling stocks when they are cheap occurred in the credit crisis of 2008. $147 Billion of assets were pulled out of U.S. stock mutual funds that year (Investment Company Institute). The subsequent recovery yielded a cumulative return of 45.6% spanning the 2 year period of December 2008 to December 2010 (S&P 500). A $1MM portfolio invested in the S&P would have missed out on an investment return of $456,000.

Behavioral counseling is an advisor’s way to help clients avoid these types of emotional investment decisions. While there are many behavioral factors that can adversely affect an investment strategy, Loss Aversion and Narrow Framing stand out as two that prove time and again to be great destroyers of wealth. As you begin to understand how these behaviors manifest, you can soon understand the importance of not giving into them and keeping with a set strategy.

Investor Behavior #1: Loss Aversion

One of the most common behavioral tendencies is Loss Aversion. Loss Aversion typically presents itself during a market decline, when the investor panics and sells investments at a low point. Proper counseling helps identify a portfolio solution that matches the investor’s risk tolerance. Having the right strategy and proper expectations can help the investor use perspective to ride through the tough times without selling out. This is easier said than done. For example the bear market of 2008-2009 was the worst market environment we have seen since the late 30’s. Living through the experience tested the risk tolerance of all investors with real-life consequences, not just past historical data and questionnaires about how you feel when you experience an investment loss. I believe it is safe to say that the investment world has a stronger focus on risk today than at any point in the past few decades.

Investor Behavior # 2: Narrow Framing

Another common behavioral tendency is Narrow Framing. This involves making quick decisions without considering all of the implications. With the 24/7/365 news cycle reporting on the latest crisis every minute of our day, it is difficult to maintain proper perspective as a long-term investor. The real risk for a long-term investor is losing money and not making it back. Under that definition, there is hardly ever a reason to abandon a well thought out investment strategy since short-term losses will be recouped over time, assuming the initial strategy is sound. However, investors have struggled to maintain their confidence and perspective in the face of the media’s short-term business plan. While the media serves as a good source to gain the most current market information, it is important to discuss any concerns with your advisor, in order to separate facts from propaganda and put them into the context of your investment plan.

Long Term Perspective is Key

The role of a financial advisor is just that; to advise their clients in making sound financial decisions based on their individual situation. Your Wealth Manager and their team understand the science behind behavioral tendencies, which allows them to shift to the art of helping clients determine an appropriate strategy that they can stick to through good and bad times. Once that strategy is set, it is their job to counsel investors during times of weakness, reminding them about why they chose this long-term approach to investing and where they can expect to see blips come and go.

Conclusion

Mutual funds account for $11.6 trillion of assets*. With investors over the past 20 years giving up approximately 58% of the return they should be achieving in these funds and 85% of the return they should be achieving in bond funds, the problem has reached epidemic status (Investment Company Institute)*. In no way am I suggesting that an investor must have a crystal ball to help them time the market. By simply ending this cycle of mistiming the market through destructive behavioral mistakes, investors can achieve superior results leading to a more fulfilling quality of life into and throughout retirement.
Important Disclosure Information

Please remember that different types of investments involve varying degrees of risk, including the loss of money invested. Past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments or investment strategies recommended or undertaken by RegentAtlantic Capital, LLC (“RegentAtlantic”) will be profitable. Please remember to contact RegentAtlantic if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request. This presentation is not a substitute for personalized advice from RegentAtlantic. This information is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed in other businesses and activities of RegentAtlantic. Descriptions of RegentAtlantic’s process and strategies are based on general practice and we may make exceptions in specific cases.

Index Definitions

S&P 500 Index: The S&P 500 is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe. Each constituent in an index is weighted by its market-capitalization, as determined by multiplying its price by the number of shares outstanding after float adjustment. The price return of an index is a measure of the cap-weighted price movement of each constituent within the index.