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Sometimes, We Are Our Own Worst Enemy

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To paraphrase Barry Ritholtz, a financial author, newspaper columnist and frequent commentator on Bloomberg Television, "when it comes to investing, we are our own worst enemy." How can this be? For years, we've read financial publications and self-help guides. We've listened to financial broadcasts and podcasts. We all know to set long term goals and invest for the future, and we know the importance of managing fees. We understand the goal is to buy low and to sell high. What makes investing so hard? How are we doing?

According to Dalbar's 2016 Quantitative Analysis of Investor Behavior, not very well. For the twenty-year period ending 12/31/15, the average asset allocation fund investor (your typical diversified portfolio investor), has realized an annual return of 2.11%*. Yet a custom "benchmark" representing 50% of the S&P Index and 50% of the Barclays U.S. Aggregate Bond Index returned 6.77% per year – more than three times the actual return realized by the average retail investor.

In 1990, Harry Markowitz, Merton Miller and William Sharpe won the Nobel Prize in Economics for their work in modern portfolio theory. Their groundbreaking work still serves as a foundation for structuring portfolios today. But such a well-diversified portfolio must be implemented and maintained, consistently and unemotionally over an extended period, in order to realize the proven benefits. This is a lot easier said than done. As Joe Nocera, another well-known business journalist, once said, "most human beings lack the skill and emotional wherewithal to be good investors." Despite his extensive financial knowledge, he put himself in this same category. The emotional wherewithal, to which Mr. Nocera refers, falls under the academic heading of Behavioral Finance. Several elements of Behavioral Finance are reviewed below.

As human beings, we are all influenced by our experiences and emotions. If we touch a hot surface and experience pain, what do we do? Remove our hand, of course. Well if we lose a good deal of money in an investment and experience pain, what do we do? The natural reaction is to unload the investment so as to avoid additional pain. This action may run contrary to the goal of buying low and selling high. It is also an example of **Myopic Loss Aversion**. We all feel the pain of loss much more deeply than the joy of a gain. Studies have shown that people choose to take a risk only when the potential for gain is two times greater than the potential loss. Such an emotional bias works against us as investors.

In another example of Myopic Loss Aversion, a 1997 study showed that a group of investors reviewing their portfolio once per year settled on an average 70% allocation to stocks. A group of investors that reviewed the portfolio much more frequently, on a monthly basis, settled on a much less risky portfolio of 41% stocks.[1] Frequent exposure to market volatility, and the subsequent experience of pain, significantly impacted the amount of risk the average investor was willing to take.

Herding – We are inclined to follow the crowd because we fear making mistakes or missing opportunities. A common adage is that two emotions drive the market – fear and greed. It's hard to go against the crowd. In fact, studies have shown that the brain actually secretes a chemical to create emotional pain if one is forced to go against the crowd. Herding is the human emotion that "fuels" the creation of market bubbles and crashes. Again, herding runs counter to the goal of buying low and selling high.

Anchoring and Home Bias – When making decisions, we have a tendency to rely too heavily on one piece of information, or upon what we know or better understand. This explains why people buy excess stock in their own company, despite the concentration risk. This also explains why investors tend to invest in their own countries. As of December 31, 2016, 74% of U.S. investor portfolios was invested in domestic stocks and bonds, despite U.S. stocks and bonds only representing 36% of global markets.[2] Southern states routinely invest more in energy companies than do other areas of the country; western states routinely invest more in technology companies; mid-western states routinely invest more in industrial companies; and eastern states routinely invest more in financials.

Overconfidence – A great majority of people think they are better, smarter and wiser than they really are. The markets are very efficient. Nobody can consistently time the market or outperform. Market actions and reactions seem so obvious in hindsight, but are anything but obvious in the moment.

Endowment Effect – Investors tend to keep investments they already own, becoming attached to an asset. Sell decisions are often harder to make than buy decisions because of emotions involved. Selling a losing investment can also feel like admitting to a mistake.

The study of Behavioral Finance is broad and extensive. I have only scratched the surface in this article. Suffice it to say that we all bring emotional baggage to the experience of investing. With advance planning and realistic expectations, and by remaining aware of our biases and emotions, we can minimize impulsive decisions and the sabotage of our portfolios. Paul Samuelson, a famous economist, once said that "investing should be more like watching paint dry or grass grow. If you want excitement, take $800 and go to Las Vegas." We certainly agree with Mr. Samuelson's long term perspective.

1 The Quarterly Journal of Economics 112.2 (1997)
2 JPMorgan Guide to the Markets, 12/31/16, pg. 68

*Source: "Quantitative Analysis of Investor Behavior Report", 2015 Update, Dalbar, Inc. The Average Equity Investor is calculated using results supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions, and exchanges. Results capture realized and unrealized capital gains dividends, interest, trading costs, sales charges, fees, expenses, and other costs.