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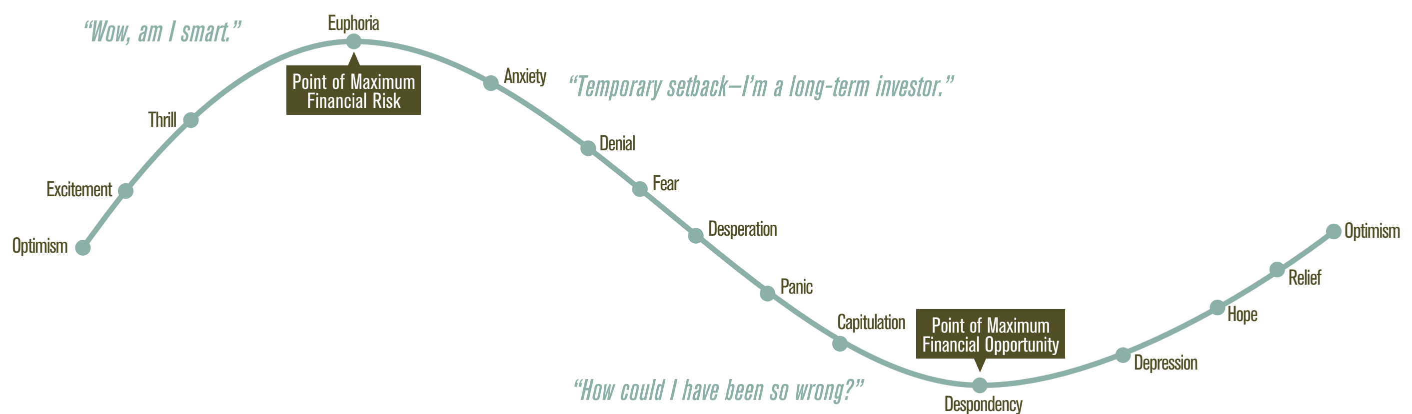
Beware of Investing's Emotional Pitfalls

Many people spend a great deal of time and effort putting together a financial plan to fund all aspects of their lives, including buying a home, having children and putting them through college, insuring against unexpected events, and maintaining a comfortable lifestyle in retirement. To achieve these quantifiable goals, the plan must include a calculated investment strategy that can provide at least the minimum required rate of return.

A prudent investment strategy generally encompasses various types of assets — domestic stocks, international stocks, bonds, commodities, etc. — that are expected to produce differing rates of return in any given time frame. Combining dissimilar investments effectively insulates a portfolio, making it less susceptible to the highs and lows of each of the underlying assets. Ideally, this insulation gives investors confidence that the building blocks of their asset allocation provide a stable, long-term investment foundation and helps them tune out the noise associated with short-term performance. Unfortunately, this is easier said than done. Technology has certainly made us all more demanding of instant gratification, but that's not even the biggest challenge. In our view, the biggest obstacle investors face in staying committed to their long-term plans is managing their own emotions during the ups and downs of the market. As Exhibit 12 illustrates, investors' emotions can be as volatile as the markets themselves, and succumbing to those emotions would generally lead investors to zig precisely when they should zag.[1] »

EXHIBIT 12 MARKET PSYCHOLOGY



Source: The Financial Philosopher

To illustrate this point, we can look at cumulative stock and bond purchases by individual investors, which we consider to be a proxy for investor behavior, within a given time frame. From 2007-2012, retail investors withdrew a cumulative $618 billion out of U.S. equity mutual funds while investing $829 billion into bond mutual funds.[2] In our view, investors became fearful in 2007, and, due to the ensuing financial crisis, they spent the next five years running for temporary cover in bonds as they moved through the market psychology cycle from desperation to depression. We certainly recognize that this was an extremely difficult period for investors; that's exactly why we spent thousands of hours during those years counseling our clients to stand firm and adhere to their long-term plans.

As evidence suggests, buying stocks when they are cheap—typically when the stock market feels scariest—generally leads to a higher return than buying stocks when they are trading at expensive valuations (see Exhibit 10 in the previous article, "Investing for the Long Run"). And yet, when the market was at its recent bottom, many investors lost sight of this fact, choosing to sell stocks after experiencing significant losses rather than seeing it as an opportunity to invest in the world's best companies at great prices. As financial advisors, we believe it's our job to persuade our clients not to allow their emotions to steer them toward these costly mistakes.

If we examine results over a longer period of time, the impact that emotions can have on investors' returns becomes even more pronounced. According to market research firm Dalbar Inc., the average investor's investment allocation over the last 20 years produced a rate of return of just 2.53% annually, versus the average annual return of 9.9% for the S&P 500.[3] It's hard to imagine that earning a paltry 2.53% annualized return over a 20-year period would enable most investors to meet their long-term goals.

So, if you find yourself considering a change in your investment plan, please first discuss with your advisor whether this is a reaction to short-term results that did not meet your expectations. Are you trying to time the market based on a hunch about what will happen in the next year? Did your stocks produce a negative return last year? Did your international stocks underperform your domestic stocks in recent years? We would strongly caution you against reactionary measures or attempts to predict near-term market movements, as we firmly believe that these do not pay off in the long term. Instead, we would understandingly reemphasize the rationale underpinning your asset allocation, which we customized based on your individual goals. In many cases, the best course of action for investors during periods of doubt, disappointment, or fear may be the most difficult one: to stay the course and do nothing.

In summation, most investors will be faced with disappointing investment results in a number of years of any given decade. Ultimately, a thoughtfully crafted investment plan should provide the confidence to behave rationally during volatile markets or periods of short-term disappointment. There are many valid reasons to make small adjustments to your investment and financial plan over time, but acting on your emotions will often do more harm than good. ■

1 *Kent Thune, "Nary Quite Contrary ... 2009," The Financial Philosopher (blog), December 11, 2008, http://financialphilosopher.typepad.com/thefinancialphilosopher/2008/12/nary-quite-contrary-2009.html.*
2 *Cumulative data is for calendar years 2007-2012. "Guide to the Markets," March 31, 2015, www.jpmorganfunds.com.*
3 *"Emotions and Investing, How the Individual Investor Stacks Up," www.blackrock.com/investing/literature.*

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Index Descriptions

- The S&P 500 is widely regarded as the best single gauge of the U.S. equity market. It includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 focuses on the large-cap segment of the market and covers approximately 75% of U.S. equities.
- The Euro Stoxx 50 is Europe's leading blue-chip index for the eurozone, providing a blue-chip representation of super-sector leaders in the eurozone. The index covers 50 stocks from 12 eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

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