MAINTAINING PERSPECTIVE IN VOLATILE MARKETS

THE RETIREMENT GROUP LLC

PARTNERS IN RETIREMENT

TABLE OF CONTENTS

Behavioral Finance

While it's true that the market is extremely efficient, changing in value and price within seconds of newly released information, these changes are not always correct or predictable. In the short run, investor emotions are the most influential factor that drive the market[4]. This has led to the study of behavioral finance to determine what natural human tendencies can explain irrational market anomalies. In many economic and financial models, the base assumption is that people rationally choose the best option to increase their wealth. If this were true, then anomalies such as the January effect (returns in January are historically the highest of any month[5]) effect wouldn't exist. Regardless of outside factors such as what day of the year or week it is, a rational investor would choose to buy low and sell high, which is not specific to any calendar month or day of the week. Buying low and selling high has to do with how the general market is currently priced as either undervalued or overvalued. So while there is a lot of debate over the causes of the many market anomalies, behavioral finance looks to explore human psychology as it pertains to financial decision making. By realizing these counter-productive tendencies, we can train ourselves to actually become rational, investing individuals.

Anchoring

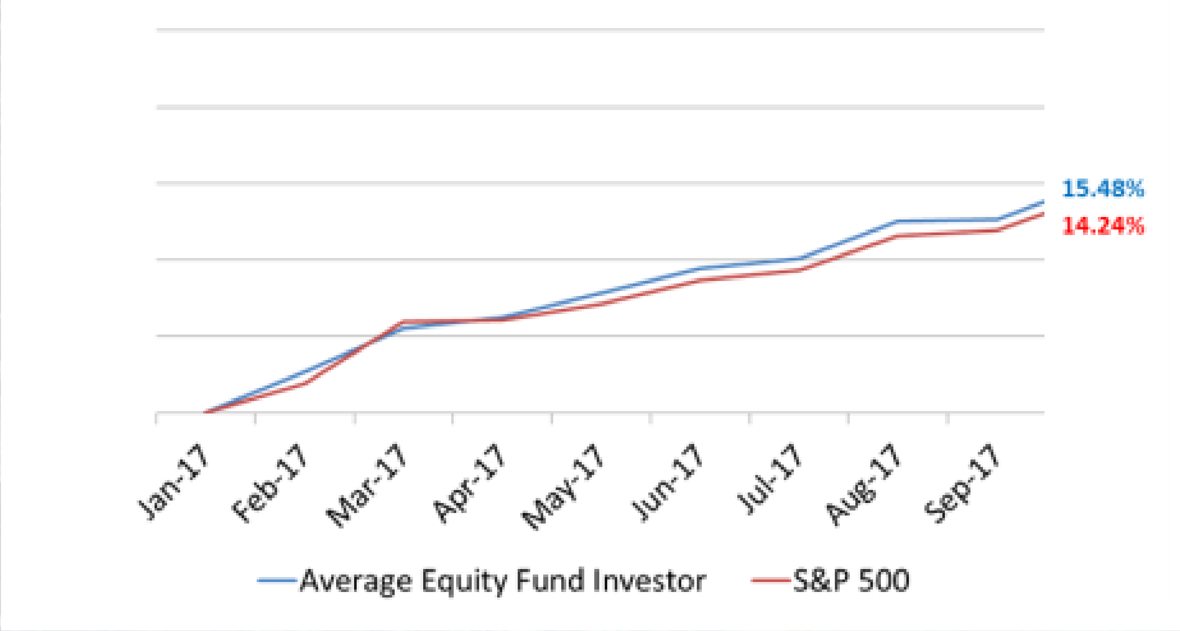
One of the concepts that behavioral finance investigates is "anchoring". Anchoring is any conventional thinking to which we base our decision making. For instance, how we view the price of goods is "anchored" by our perception of how much we believe should be paid for a given item. Having a solid anchor and foundation to which you consistently evaluate investment options should be the goal for all investors. Where many investors go wrong though is having an "anchor" that changes relative to short term sentiments. In this sense, the investor doesn't stick to a consistent strategy and invests based on fears or optimism of recent trends. This results in a counter-intuitive approach of buying high and selling low.

After multiple periods of continual losses in the market, many investors get pessimistic and begin to sell their shares. But when you think about it, when stock prices are declining, the stock begins to devalue and become more and more of a bargain. Essentially, these investors are selling at the lows. Then as the market picks up again, the losses of the recent periods are still fresh in the investor's mind. But by being more conservative and cautious at the low, they miss out on the gains when the market rebounds. Then by the time these investors regain confidence in the market after the recovery, they end up buying when the market is inflated and no longer as much of a value. Trying to time the market is already extremely difficult, but doing so when clouded by short term emotions make it nearly impossible and actually contributes to below market or negative gains.

Gambler's Fallacy

Before I go into some data that supports this theory, I want to highlight how having an inconsistent and ungrounded anchor leads to another behavioral finance concept: the gambler's fallacy. When investors view the market optimistically or pessimistically, that effects how they view where the market is headed.

For instance, after multiple periods of losses, there is a perception that the market will be due for a rebound soon. But how long a bear market continues on for is irrespective of how long it has already been going on. This can lead to buying into the market prematurely while it continues to decline. On the other side, after multiple periods of gains, some investors feel that the market is due for a loss. We can see the negative effect this had on investors in the DALBAR report shown below.



Gambler's Fallacy Example

Heading into the 4th quarter of 2017, the average equity fund investors was on pace to outperform the market for the first time since 2009. Yet, two of the three best performing months of the year (October and November) coincided with relatively large outflows in equity position[2]. What this shows is that many investors were expecting losses after three strong quarters and tried to time the market and get out beforehand. Ultimately what happened was the market continued its bull run and the average equity investor earned a lower return than the market. At year end, the average equity investors only underperformed the market by just over 1% but in the long run this adds up.

Herd Mentality

Another big behavioral finance concept is the idea of herd mentality. People generally feel a strong social pressure to fit in and conform with those around them, even when it involves something we don't quite understand. Before the dotcom bubble burst, many venture capitalists and private investors frantically made moves to invest money into internet companies, with little knowledge of the business models and how the companies were making money. It's easy to look back now and realize the flaw with this. But at the time, it was a much different environment. Imagine that many of your close friends and neighbors were investing in a certain stock which was experiencing massive gains. Even though you don't quite understand what you're investing in, it's hard to sit by and do nothing when you see your peers being so successful. Naturally, you'll decide to buy in too and try to join in on the winnings. On the flip side, trying to invest in more uncommon securities can have a larger emotional toll. If you guess correctly you'll feel very smart for having taken a unique risk. But in the event you guess incorrectly, the losses hurt even worse because most people feel regretful and isolated for taking on such a risk.

Mindset for Rational Investing

So now that we've identified some natural tendencies that hurt investment returns, let's move on to how we can correct them and develop the right mindset for successful investing. To the first point on anchoring, an investor needs to have a strong foundation from which to base their investment decisions. Even the most successful investors underperform the market in some years but what makes them so successful is that they stick to consistent, proven strategy that works over the long run. As I noted in the beginning how the market is driven mostly by emotion in the short run, in the long run the market usually gets things right. As the forecasted figures turn into actual data and analysts can see what actually happened, the market more accurately can price securities more in line with intrinsic value. A value investing approach is a great way to keep a level head when investing. By basing investment choices on the intuitive ideology of buying good companies for a cheap price, you can avoid the mistake of reacting to short term news and have confidence the stocks you own are worth more than what you paid for them.

Value Investing

In theory it sounds simple to ignore under performance in the short term but doing so takes a lot of patience and strong will. Value investing is often called contrarian investing because it is opposite of the status quo. Being able to tough out poor returns for extended periods while playing the long term game, especially when those around you are faring better, is what separates successful investors from the rest. Understanding why you're doing something and believing in it is one of the only ways that you'll end up sticking to it.

So if you'd like to look at historical evidence that highlights the dominance of a value investing strategy, check out our other white paper titled "What Has Worked In Investing". Value investing uses the same rational that you would use in the purchase any other good or service. The way a rational consumer decides what to buy is based on the value received. If you're deciding on a new car to buy, some of the things you might consider are the price, the features, the performance, and the reliability. Then you'll make your decision based on what the best car you can get for the best price. If there are two options that have very similar features and quality, yet one is half the price of the other, you'll likely go with the cheaper option. This is the same philosophy behind value investing. When looking for which stocks to add to your portfolio, you should look to find the best companies at a cheap market price relative to the actual intrinsic value.

Conclusion

As mentioned before, the market is driven by emotion in the short run and this results in the market under and overpricing certain companies. By choosing your investments based on which companies are underpriced rather than what day of the week it is or what has happened in the market recently, you have a strong anchor to which you base your investment decisions. Having a strong anchor is also a great way to stay grounded from herd behavior. One of Warren Buffett's famous sayings goes "to be fearful when others are greedy and greedy when others are fearful"[1]. So by having a strong anchor and thinking independently of the status quo, you can remain confident during volatile markets and be successful over your long investment horizon.

Sources

[1] Brownlee, Adam. "Warren Buffett: Be Fearful When Others Are Greedy". Investopia. June 25, 2018 <https://www.investopedia.com/articles/investing/012116/warren-buffett-be-fearful-when-others-are-greedy.asp>

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[3] Phung, Albert. "Behavioral Finance". Investopia. 2017 <https://www.investopedia.com/university/behavioral_finance/>

[4] Rick, Scott. "Handbook of Emotions: The Role of Emotion in Economic Behavior". The Guilford Press. 2008 <https://www.cmu.edu/dietrich/sds/docs/loewenstein/RoleEmotionEconBehav.pdf>

[5] Kay, Amanda. "What is the January Effect". Investing News. January 3, 2018. <https://investingnews.com/daily/resource-investing/what-is-the-january-effect/>

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