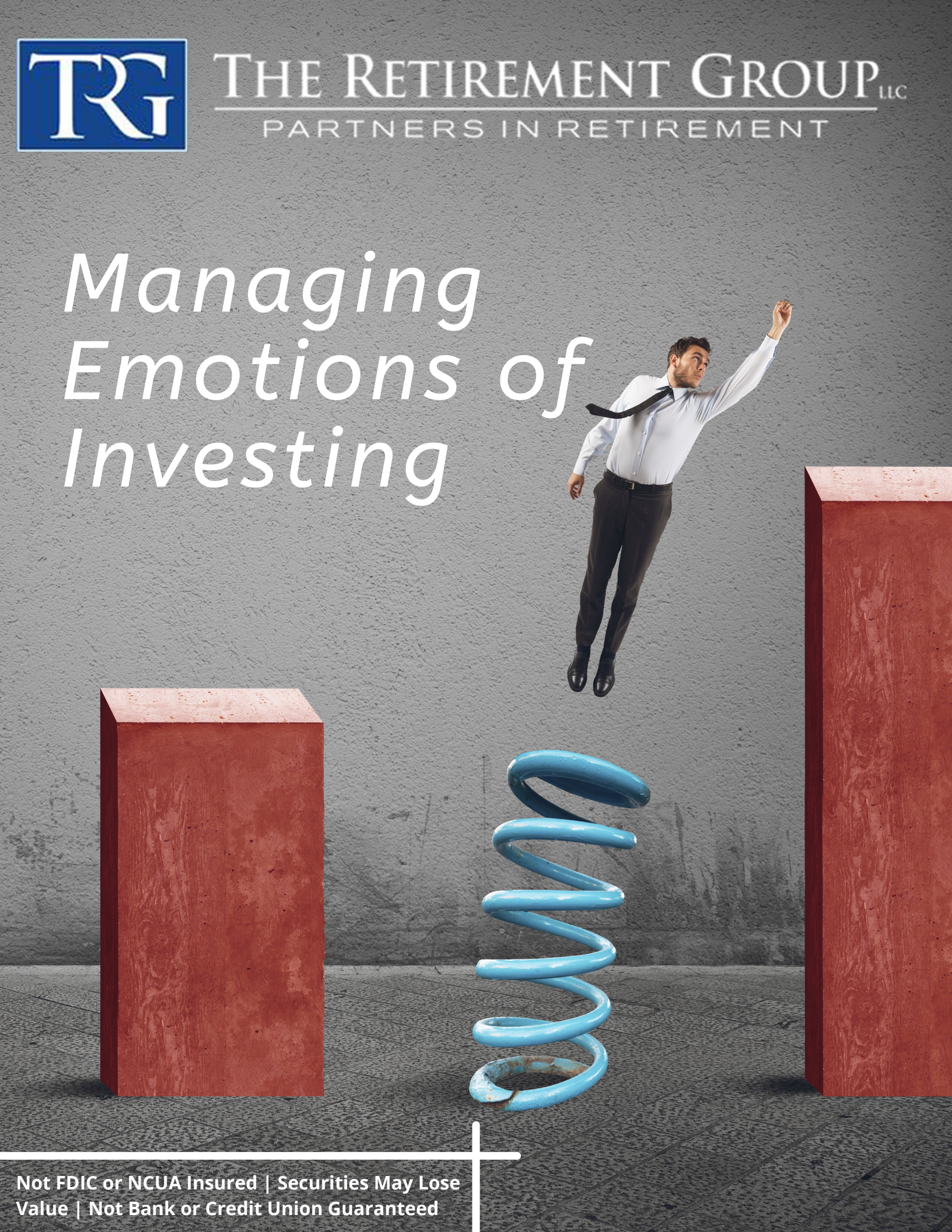
THE RETIREMENT GROUP LLC

PARTNERS IN RETIREMENT

Managing Emotions of Investing



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Introduction

Many investors find it difficult to achieve their financial goals for a number of reasons. Unexpected and uncontrollable events can wreak havoc on a financial plan. But often it is the investor's own actions that cause them to fall short of their objectives. There is a branch of science called behavioral finance dedicated to exploring how people's propensities and predilections can short circuit rational investment decisions. Unfortunately, the investment environment comprised of academicians, practitioners, pundits, and the financial press is complicit in steering the investor to return-diminishing behaviors such as Market Timing, Performance-Chasing or following the herd (usually off the cliff). Fortunately, awareness aids avoidance. This paper covers these emotions and offers tips on how to better manage emotions in all stages of the market cycle.

There are many catalysts that affect the stock market – the internal workings of a company, worldwide events, inflation rates, etc all influence the way stock prices rise and fall. In addition to those factors there is an emotional and psychological influence at work which determines how we make decisions when buying and selling in the market. These emotions can cycle from over-optimism to despair (and lack of confidence) and can lead to buying at market tops while selling at bottoms and maybe exiting the market completely, missing out on returns and locking in losses.

Let's face it, investing is difficult and the human brain makes it harder. That is why even the smartest people are affected by cognitive biases, especially when it comes to investing. We are in an elevated market and with that come emotions of giddiness, greed, and overconfidence.

Productivist

While there is a wide range of emotions that are experienced while investing, there are four main ones that play the biggest role in decision making: Pessimism, Optimism, Euphoria (Greed), and Fear[5].

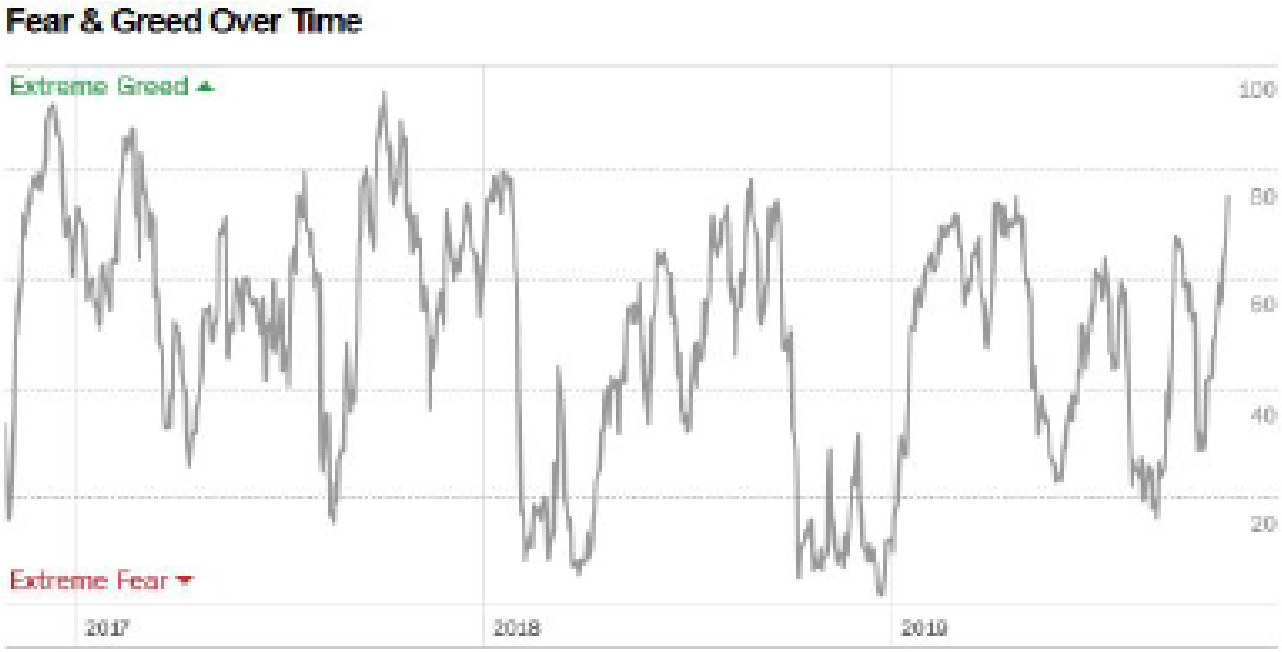
1. **Pessimism** – As the market enters the accumulation phase after a steep decline in prices, investors recovering from the psychological disappointment are in the pessimistic stage. During the accumulation stage, asset values begin to consolidate and investors still perceive the market as bearish, causing hesitance to buy. The downtrend will be perceived as permanent and will fear rejoining the market and experiencing greater loss more than they fear missing out on the start of a new bull market.

2. **Optimism** – Seeing that markets are gaining upward momentum, investors tend to shake off their remaining negative sentiments from the previous decline. Due to actions of investors in the accumulation stage who invested in stocks at or near lows, the drops in the market become smaller than the rises. This leads investors to regain some confidence that the money they invest will bring returns.

Source: https://medium.com/productivist/the-bull-and-the-bear-a327bb7b063c%20

3. **Euphoria (Greed)** – Prices peak, and while some investors start realizing profits, other investors – filled with overconfidence – will feel comfortable investing in additional assets. It appears that the bull market will never end, leading investors to blindly invest and take on more risk to prolong the feeling of success.

Source: https://money.cnn.com/data/fear-and-greed/



4. **Fear** – While those investors are boasting about their unrealized gains during a bull market, prices start going down in a volatile downtrend. Some will dismiss as a small correction, but overconfidence can blind people from realizing exuberance has led to overvaluation and speculation. As the decline continues, doubt begins to creep into investors' mindsets and eventually develops in a panic. Some investors will hold onto their assets too long to avoid realizing a loss. This sets them up to sell aggressively when fear and anxiety about the lack of performance from their holding reaches peak levels.

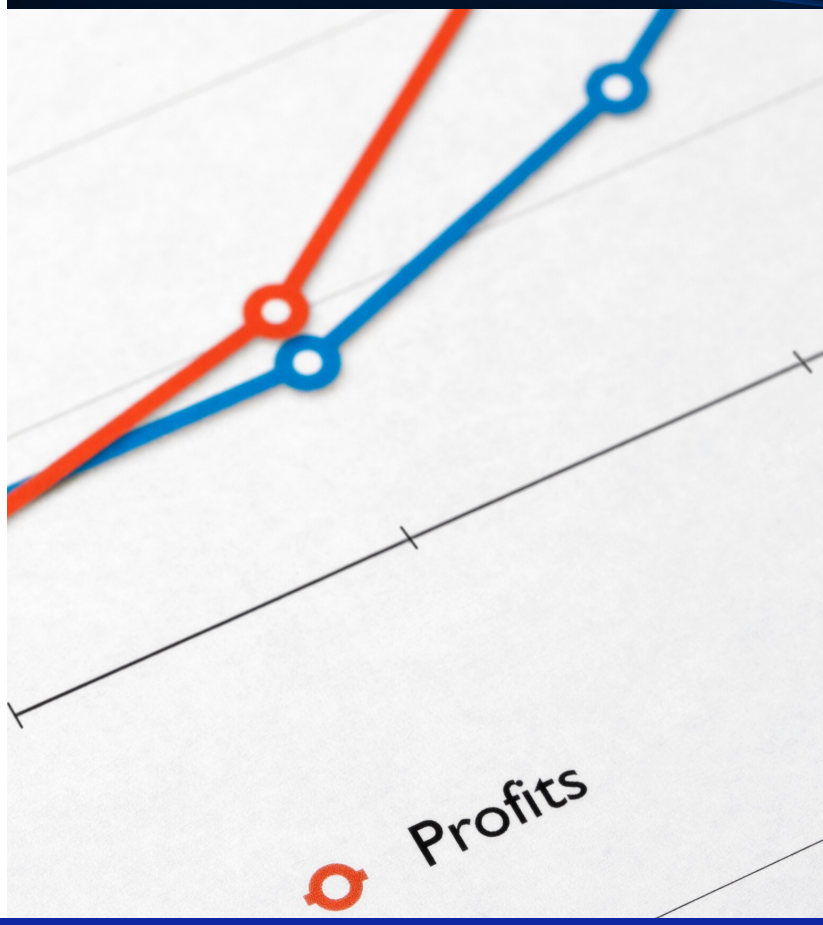
Short Term vs. Long Term

Performance in the short term can cause anxiety, but looking at short-term performance vs. long-term performance of the same index can bring more clarity. Figure 5 below shows the annualized returns that an investor in the MSCI World Index would have experienced over time, depending on whether they focused on long- or short-term returns.

The orange line shows a rolling window of annualized 10-year returns and illustrates the perception that should dictate our decisions; a long-term strategy. 96% of the time, the 10-year rolling returns are positive with the only negative period occurring during the financial crisis of 2008[1].

The blue line on the other hand illustrates rolling 1-year returns. This helps show the perspective of how most investors choose to view their returns. The same investment can feel completely different depending on the time frame over which we observe it. This chart points out just how volatile returns can be when a short-term horizon is used, and unfortunately, psychologically it is hard to focus on long-term gains when experiencing extreme volatility in the short-term.

(Graph is on next page)



Short Term vs. Long Term

One year is an optimistic holding term for most investors in calm times; in more volatile markets emotional horizons can be even shorter.

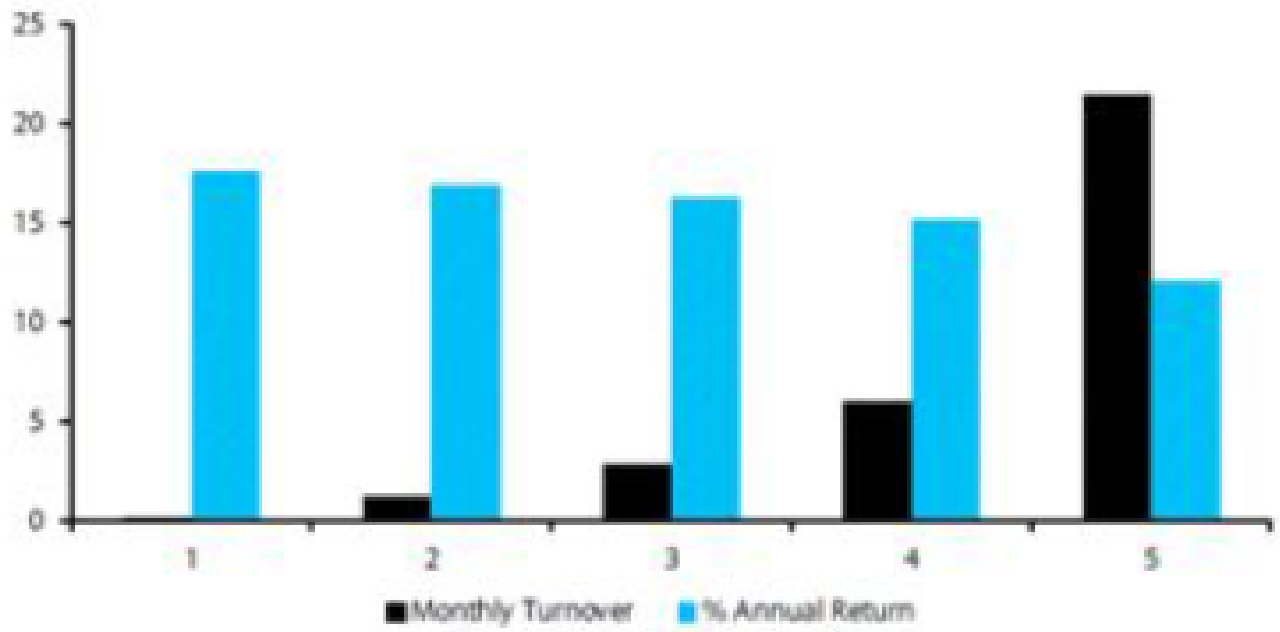
A short-term evaluation period can be hazardous to your wealth. One way people make themselves comfortable during a volatile market is by trading excessively to "take advantage" of perceived patterns in the market. While some activity must take place in a portfolio (rebalancing asset classes, buy undervalued/selling overvalued positions), frequent trading is often a response to random market movements when in actuality the risk-return aspects of the asset hasn't changed. The short-term emotional component of these decisions tends to lead people to take more risk when they are comfortable and reducing it when they aren't. In other words, buying high and selling low.

Source: https://www.aag.co.uk/news/even-keel/

For example, one study grouped investors into five groups based on their portfolio turnover. The lowest turnover group turned over less than 1% of their portfolio each month while the highest turnover group turned over nearly 25% of their portfolio each month. One would think that the more active investors would outperform as the activity would move them out of less desirable investments into more attractive ones. In fact, the opposite was true, with the less active investors significantly outperforming their more active counterparts (see Figure 6 below)[1].

Source: http://www.barclayswealthportal.com/en_gb/home/research/research-centre/white-pape%20rs/Behavioural-Finance/Cycle-of-investor-emotions.html

Figure 6: Trading can be hazardous to your wealth



Short Term vs. Long Term

DALBAR (a company that provides analysis and evaluation of businesses, products, and customers in the financial industry) releases an annual Quantitative Analysis of Investor Behavior (QAIB) report, which captures individual investor behavior and compares it to an institutional approach. Since 1994 the QAIB report has measured the effects of investor decisions to switch into and out of mutual funds over short and long-term timeframes. Through this analysis, the QAIB has shown that investment results are more dependent on investor behavior than fund performance.

Their most recent report covered the period from January 1, 1988 to December 31, 2017 and utilized mutual fund sales, redemptions and exchanges each month as the measure of investment behavior. Based on this behavior, they computed "average investor return" and compared those returns to those of their respective industries. Below is a summary of important findings in the report[3]:

Short Term vs. Long Term

- In 2017, the average equity mutual fund investor underperformed the S&P 500 by a margin of 1.19%. (20.64% vs. 21.83%)
- Two of the three best performing months for the S&P 500 (October and November) coincided with relatively large net outflows of assets
- The average mutual fund investor did not stay invested for a long enough period to execute a successful long term strategy. There were numerous instances in which market conditions created a shift in cash flows opposite to the eventual direction of the market

The findings from DALBAR demonstrate the inability for investors to have a long-term investment perspective. 2017 was a very strong year for the market and yet mutual fund investors on average still underperformed the market. Given the counter-productive actions of these fund managers, it's clear that many of them were fearful and cautious of the current market conditions. In the graph below, you can see the average equity fund investor was on the verge of outperforming the market over a 12 month period for the first time since 2009[3].

Short Term vs. Long Term

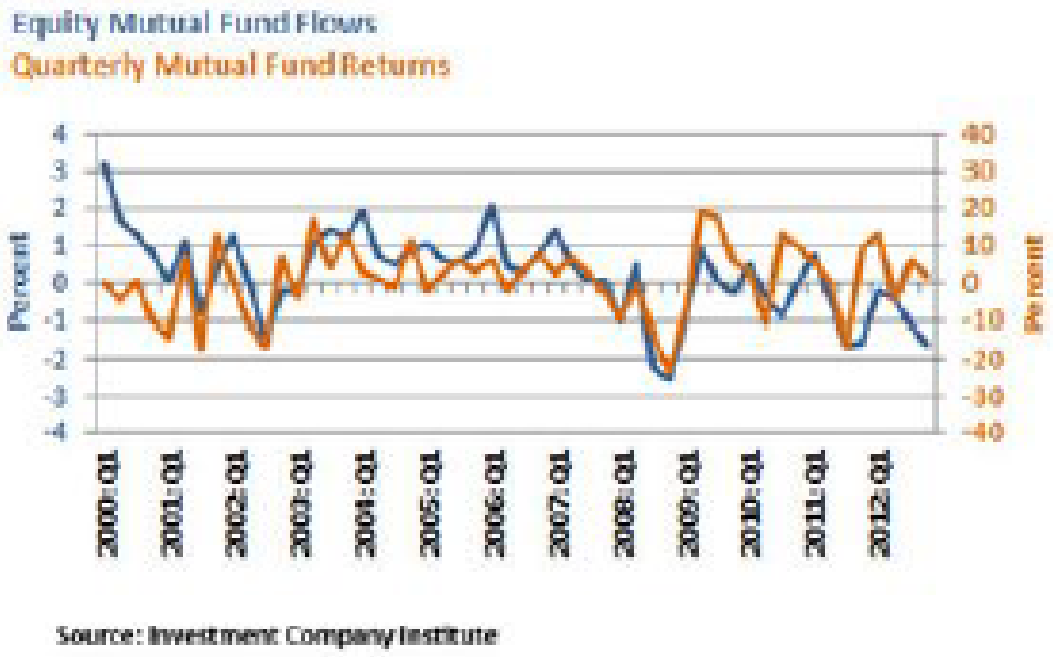
As mentioned, there was a relatively large shift out of equity positions in the fourth quarter, which was ultimately some of the best performing months of the year. This indicates that many investors were in the pessimism stage, feeling that after 3 quarters of solid gain that the market was due for a correction or downturn. It is this kind of short-term investment rationality rather than some unforeseen market events that consistently diminish investor returns.

Source:https://content.swanglobalinvestments.com/hubfs/Third%20Party%20Documents/Dalbar%202018%20QAIB%20Report%20-%20Quantitative%20Analysis%20of%20Investor%20Behavior%20-%20Advisor%20Edition.pdf

	Average Equity Fund Investor (%)	Average Fixed Income Fund Investor (%)	Average Asset Allocation Fund Investor (%)	Inflation (%)	S&P 500 (%)	Bloomberg-Barclays Aggregate Treasury Index (%)
20 Year	5.29	0.44	2.58	2.15	7.20	4.60
10 Year	4.88	0.48	2.52	1.64	8.50	3.31
5 Year	10.93	-0.40	5.41	1.48	15.79	1.27
3 Year	8.12	-0.05	3.85	1.71	11.41	1.40
12 Month	20.64	1.52	10.08	2.11	21.83	2.31

Short Term vs. Long Term

In a 2014 study by Federal Reserve Senior Economist YiLi Chien, he looked at the correlation between U.S. equity mutual fund flows from 2000 to 2012 (illustrated in graph below). It is easily apparent that U.S. equity mutual fund flows are positively correlated with their past returns (correlation coefficient of 0.49)[2]. This indicates return chasing behavior.



Short Term vs. Long Term

The emotional response to poor performance in a mutual fund is to pull it out and put in a fund that has had positive performance on the year. This leads to return chasing, and given that stock markets are nearly impossible to predict in the short run and reverts to mean in the long run, the tendency to buy high and sell low when chasing returns will reduce profits.

Emotions in investing can lead to poor analysis and decision making as well as performance chasing. To correct these natural tendencies, investors need to develop a long term view when investing or hire an intermediary who will help put their emotions into perspective and help them remain invested during market turbulence. The goal for investors is to get away from this short term thinking and view sectors of the market as either under or overvalued relative to long-term industry averages. Looking at current trends isn't a bad thing per se, but making frequent trades based on these trends is where many investors go wrong. That's why one of the main benefits of having a trusted financial advisor is a level-headed voice of reason.

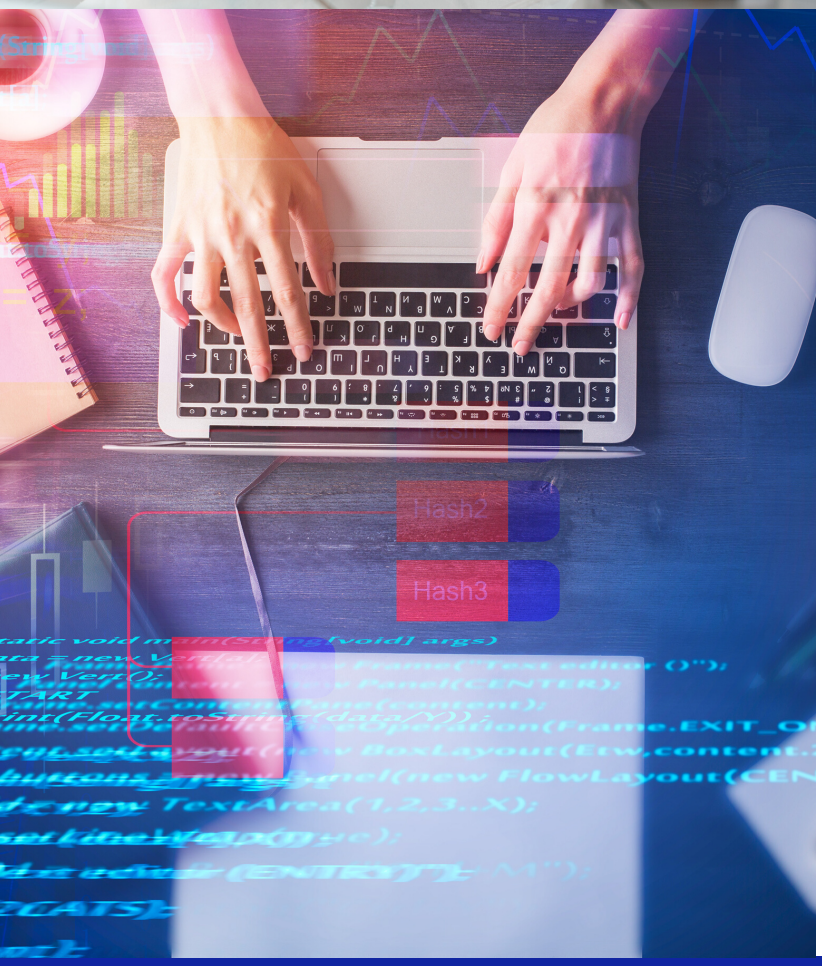
7 Tips for Removing Emotions from Investing

1. Establish long-term financial goals

Knowing your financial goals, risk tolerance, time horizon, etc. can help you establish a long-term plan for investing. It is easy to get distracted by short-term losses when focused on short-term gains, but if you have set rules and a longer time horizon, it can be helpful to stay calm during times of high market volatility.

2. Use Cash as a position

Holding sufficient cash can reduce big emotional swings that come with being over-invested in the stock market. Warren Buffett has advocated using 90/10 equity to cash ratio, but a good rule of thumb is to have enough cash to cover 12-month of expenses.
(https://www.investopedia.com/terms/1/90-10-strategy.asp)



3. Diversify

By diversifying your portfolio across multiple asset classes and sectors, you can reduce wild swings and extreme market risks. Having a portfolio that's balanced and diversified in many areas can inadvertently prevent you from making rash decisions.

4. Dollar-cost average

This strategy involves invested equal dollar amounts at a regular, predetermined interval. During a downtrend, investors are purchasing shares at cheaper prices. During an uptrend, previously held shares are earning capital gains and fewer "expensive" shares are being bought. DCA can possibly lower the total average cost per share of the investment.

Disclosure: Neither Dollar Cost Averaging nor Diversification can guarantee a profit or protect you from losses in a declining market. Investings always involveds risk, including the potential loss of principal.

5. Take news with a grain of salt

Reacting to major news in the stock market is easy, but it is also how a lot of people make investment decisions based on emotions. Unfortunately a lot of news isn't materially pertinent to the future performance of a company, and it is difficult to separate news from noise. When the typical investor reacts to news, it tends to lead to uneducated and uninformed investment decisions. Instead of reacting to headlines, use the news as a minor data point in a plethora of other gathered information.

6. Don't "follow the herd"

Along the same lines as reacting to news comes following what others are doing. A perfect example of this is the Bitcoin phenomenon of 2018. Once you see other people have success doing it, you believe that you can too and – oftentimes – jump in too late to realize meaningful returns (or at least have the same amount of success).

7. Speak with a financial advisor

Using someone who has experience in with various financial situations and markets can leverage that experience to make rational decisions regarding investing. Mental and financial coaching is the typically the biggest services that a financial advisor can offer. Not only can an advisor serve as an emotional coach, but they typically have access to more tools and resources to make more informed investment decisions. A financial advisor can help clients remain cool, calm, and collected during periods of high market volatility, remain focused on long-term goals and make informed investment decisions.

Sources

[1] Barclays. “Cycle of Investor Emotions.” Barclays, 2017, wealth.barclays.com/en_gb/home/research/research-centre/white-papers/Behavioural-Finance/Cycle-of-investor-emotions .html.

[2] Chien, YiLi. “Chasing Returns Has a High Cost for Investors.” St. Louis Fed, Federal Reserve Bank of St. Louis, 14 Apr. 2014, www.stlouisfed.org/On-The-Economy/2014/April/Chasing-Returns-Has-a-High-Cost-for-Investors.

[3] DALBAR. “Quantitative Analysis of Investor Behavior.” DALBAR, 2018, <https://2wmko64dug4x3dv4oh97ijl9-wpengine.netdna-ssl.com/wp-content/uploads/2018/04/2018-QAIB-Report_FINA L.pdf>

[4] Frownfelter, John. “The DALBAR QAIB: It's Behavior (Not Performance) That Hurts Investors Most.” SEI's Practically Speaking, SEI, 18 Apr. 2017, seicblogs.com/advisor-practice-management/client-service/client-communication/the-dalbar-qaib-its-behavior-not-perfor mance-that-hurts-investors-most/.

[5] Harden, David. “The 4 Stages of the Investor Emotion Cycle.” Investopedia, Investopedia, 17 Aug. 2017, www.investopedia.com/advisor-network/articles/4-stages-investor-emotion-cycle/.

[6] Meyer, Robert L., and CEO/CIO for Ibis Capital. “Investment Psychology 101: Don’t Let Emotions Influence Your Investing Decisions.” CNBC, CNBC, 4 Apr. 2017, www.cnbc.com/2017/04/03/dont-let-emotions-influence-your-investing-decisions.html.

[7] Schiel, Chad William. “Breaking the Emotional Cycle of Investing.” Schiel Wealth Management, Schiel Wealth Management, 1 Apr. 2016, schielwealthmanagement.com/blog/breaking-the-emotional-cycle-of-investing.

Additional Reading on Managing Emotions While Investing

https://www.famfunds.com/userfiles/files/White-Papers/FAM%20Funds%20Value%20Of%20Patience(1).pdf

https://www.cnbc.com/2017/04/03/dont-let-emotions-influence-your-investing-decisions.html

https://www.motifinvesting.com/blog/dont-let-emotions-rule-investing-decisions

https://www.thebalance.com/why-average-investors-earn-below-average-market-returns-2388519

https://www.investopedia.com/articles/basics/10/how-to-avoid-emotional-investing.asp

The Retirement Group is a nation-wide group of financial advisors who work together as a team. We focus entirely on retirement planning and the design of retirement portfolios for transitioning corporate employee. Each representative of the group has been hand selected by The Retirement Group in select cities of the United States. Each advisor was selected based on their pension expertise, experience in financial planning, and portfolio construction knowledge.

TRG takes a teamwork approach in providing the best possible solutions for our clients' concerns. The Team has a conservative investment philosophy and diversifies client portfolios with laddered bonds, CDs, mutual funds, ETFs, Annuities, Stocks and other investments to help achieve their goals. The team addresses Retirement, Pension, Tax, Asset Allocation, Estate, and Elder Care issues. This document utilizes various research tools and techniques. A variety of assumptions and judgmental elements are inevitably inherent in any attempt to estimate future results and, consequently, such results should be viewed as tentative estimations. Changes in the law, investment climate, interest rates, and personal circumstances will have profound effects on both the accuracy of our estimations and the suitability of our recommendations. The need for ongoing sensitivity to change and for constant re-examination and alteration of the plan is thus apparent.

Therefore, we encourage you to have your plan updated a few months before your potential retirement date as well as an annual review. It should be emphasized that neither The Retirement Group, LLC nor any of its employees can engage in the practice of law or accounting and that nothing in this document should be taken as an effort to do so. We look forward to working with tax and/or legal professionals you may select to discuss the relevant ramifications of our recommendations.

Throughout your retirement years we will continue to update you on issues affecting your retirement through our complimentary and proprietary newsletters, workshops and regular updates. You may always reach us at (800) 900-5867.

Disclaimer

Past performance cannot guarantee future results. Investing involves risk including the potential loss of principal. Current performance may be lower or higher. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Please note that individual circumstances can vary. Therefore, the information presented in this letter should only be relied upon when coordinated with individual professional advice.

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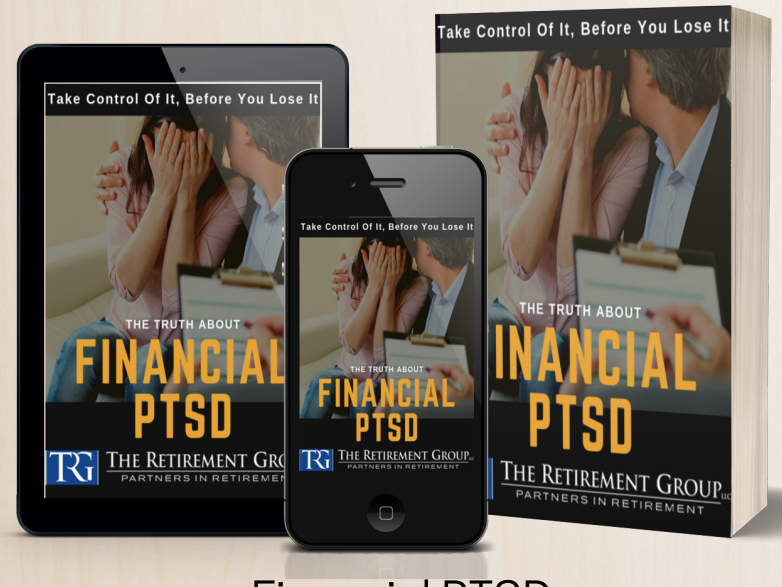
Value Investing Strategy



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