How Emotions Can Cost Investors

Oh the weather outside is frightful
But the fire is so delightful
And since we've no place to go
Let it snow, let it snow, let it snow

At the time of this writing, we are in the middle of a year that has been marred by a seemingly endless series of challenging (and sometimes chaotic) events. So far, 2020 has included a global pandemic, a recession, extreme market volatility, a liquidity crisis, and much more. And while it's currently the middle of summer, I'm reminded of a winter several years ago when Omaha was about to get hit by a powerful blizzard, expected to be among the most severe winter storms to strike the city in years. For days leading up to the storm, it seemed that every time the local meteorologists gave an update, they added a few inches to their predictions, called for more intense winds, whiteout conditions, and a generally unsurvivable event to settle upon the region.

Being the worrier in my family, I constantly checked the ever-worsening news on the impending storm. Schools cancelled classes and workplaces encouraged employees to work from home. And I admit, I fully bought into the 'snowmageddon' narrative that, even in the mildest winters, has become an annual event in cities across much of our country.

The evening before the storm set in, as I was bundling up to head out to the grocery store to take part in the Midwestern ritual of filling a shopping cart with bread and milk, my wife stopped me. Ever the voice of reason, she reminded me that we had plenty of food in our pantry, plenty of gas in the snowblower, and plenty of board games to keep the family entertained in the event of a power outage. She reminded me that our house had withstood many storms before this one. The roads always get plowed and the ice eventually melts.

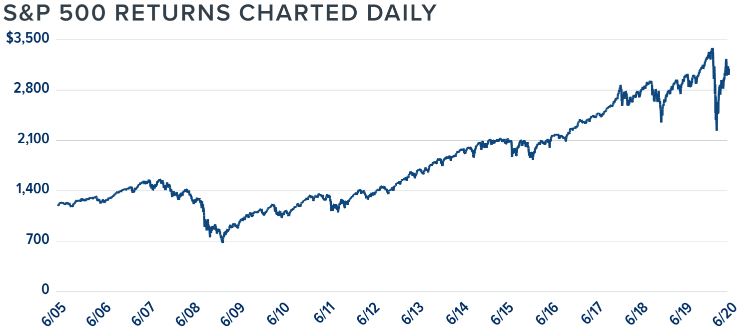
She reminded me that, no matter what happens outside – we have no place to go, so we're free to relax by the fire, watch the blizzard roll in, and let it snow!

While we did receive a healthy dose of snowfall, the reality of the storm proved to pale in comparison to the hype. By the next day, kids were in school again, offices were back to normal, and the only reminders of the blizzard were the piles of snow in front yards and parking lots.

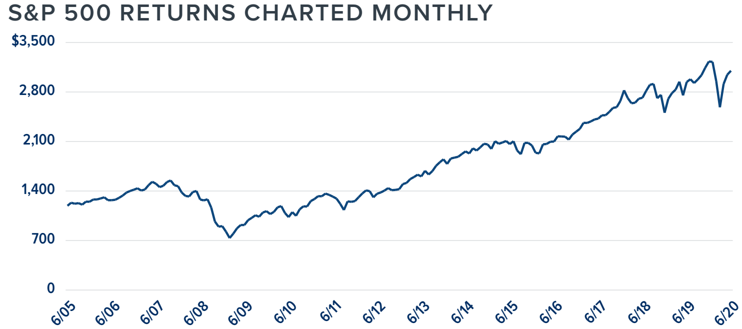
Sometimes, a disruption to the markets is like a storm. And while we can't control the weather, we can ensure our pantries are stocked and our homes have the structural ability to handle a blizzard – just as an investor should feel comfortable that their portfolio is built to weather a bout of market volatility.

And just as I would have been better served not to fret over every weather report and every inch of snow on my driveway, investors who take a long-term view don't need to worry as much about daily market happenings. Below are three charts showing stock market movements from June 2005 to June 2020. One captures prices every day, the other once a month, and the third showing just one point per year.

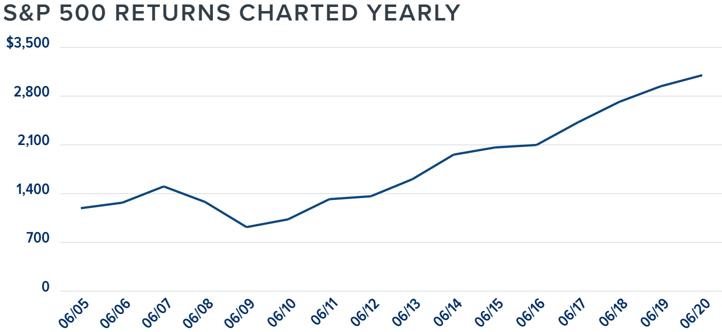
S&P 500 RETURNS CHARTED DAILY



S&P 500 RETURNS CHARTED MONTHLY



S&P 500 RETURNS CHARTED YEARLY



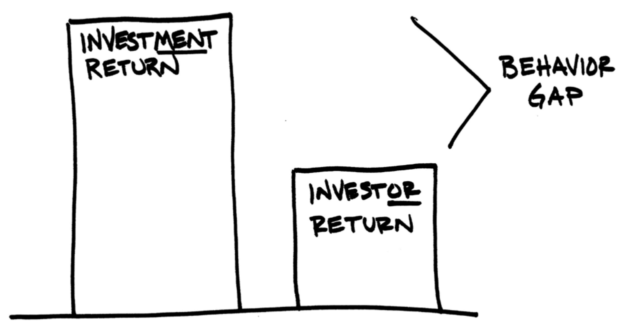
Which view gives investors the best chance to avoid the natural urge to panic? Storms are a fact of life, both in terms of weather and in terms of the markets. Those who don't focus on every single snowflake can simply relax by the metaphorical fireplace and "let it snow," knowing even the most brutal winters eventually melt away into spring.

Emotions are an investor's worst enemy

Investing is an emotional experience which can arouse feelings of sadness, happiness, fear, excitement, and dread. It may be impossible to fully separate feelings from finances, and that's because a person's financial wellbeing is tied to almost every aspect of their livelihood. From a young couple thinking about starting a family – to supporting their children's education – to, eventually mapping out their golden years, investment success offers peace-of-mind, and lack thereof can bring about an endless stream of worry.

Emotions are the cause of the "Behavior Gap" – a term coined by Certified Financial Planner™ and author Carl Richards to explain the disparity between the returns of investments vs. the returns an investor ultimately achieves. The gap is a result of investors buying when the markets are doing well (and therefore expensive) and selling when they're doing poorly (and therefore cheap).

> *"Being slow and steady means you're willing to exchange the opportunity of making a killing for the assurance of never getting killed."*
>
> *-Carl Richards, The Behavior Gap*



This pitfall is further illustrated in the Cycle of Investor Emotions chart below. It shows the gamut of emotions an investor may experience with the ebbs and flows of the market. When things are going well, feelings of optimism and excitement may prompt investors to buy. When things are going poorly, some investors might panic into selling.

THE CYCLE OF INVESTOR EMOTIONS

Benjamin Graham, the father of value investing, famously said: "In the short run, the market is a voting machine but in the long run, it is a weighing machine." In other words, short-term market movements are influenced by news, market sentiment, and popularity. But, in the long run, underlying fundamentals are what matter. Markets go up, and they go down; emotions follow suit.

"Forecasts" by financial media are less reliable than weather reports

According to the National Oceanographic and Atmospheric Administration (NOAA), 7-day weather forecasts can be expected to be accurate about 80% of the time. If the pundits on financial news networks were even close to this level of accuracy – investing would be easy.

Theatrical market news and clickbait-style reports would be harmless enough, but unfortunately, sensational headlines play a powerful role in influencing investor emotions.

The number-one goal of financial media outlets is to attract a broad audience. The easiest way to appeal to a large group of people is to make highly confident market predictions, spin news events to justify market responses, and deliver sensational headlines hour by hour and minute by minute. The financial news industry is highly competitive, and even reputable publications are doing whatever they can to keep people as customers. In other words, headlines like "the one stock you need to buy now," or "this expert's secret market indicator" are just trying to sell their audience's attention to advertisers. Nobody can regularly predict the day-to-day actions of the markets with anywhere near the level of accuracy media outlets would like us to believe.

> *"Truth be told, our team of portfolio managers and analysts would not make for great television ratings. That's because our investment decisions are not based on emotions, daily happenings, or short-term sentiment. In fact, it's normal for us to watch a company for months or years before buying. And when we do, we might hold that investment for decades. Where short-term volatility comes into play for us is in finding opportunities to be contrarian, allowing us to pay a lower price for securities we're otherwise interested in."*
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> *-Brad Hinton, CFA, Co-Chief Investment Officer*

This style of market analysis might make for higher ratings, but it also runs the risk of pushing investors off track of their long-term financial goals. It plays on people's natural tendency to value immediate payoffs, even when the future may hold far better prospects – a phenomenon known as "present bias." Someone with present bias may be more willing to take $10 today instead of $15 a week from now. Or, an investor with present bias might be willing to make a change in their portfolio based on a recent news event even if the prospects of remaining invested may deliver stronger returns in the long run.

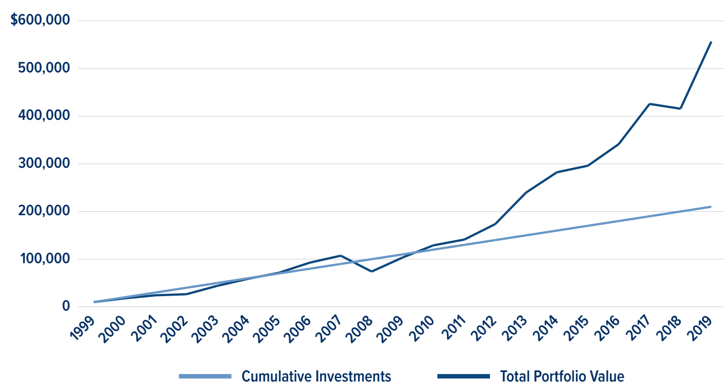
Instead of watching the financial news, investors are best served focusing on the fundamentals of selecting well-constructed portfolios that are backed by research, properly diversified, and appropriate for their particular risk appetite.

For long-term investors, it's always a good time to invest

It's only natural that someone would want to enjoy every market rally and sell just before every downturn. But attempting to do this often brings about the opposite effect. That's because many of the best days in the markets have happened within a few weeks of the worst days. Being absent from the market for only a few of the days with the highest percentage gains can decimate a portfolio's returns over time.

For those committed to sticking to a long-term financial plan, any time is a good time to begin investing. The chart below shows the progress of a hypothetical investment in the S&P 500, with $10,000 dollars invested on the **worst day** (highest price) of the year from 1999 to 2019.

GROWTH OF "WORST DAY" INVESTMENTS



Source: Morningstar Direct as of 12/31/19

Even with a consistent investment at each year's highest price, the hypothetical portfolio experienced an average annual return of +6.07%. That's a whole lot better than sitting out of the markets, just to avoid the down times. As the old saying goes, investment success is achieved not by timing the market, but by time in the market.

As for investors who are retired or nearing retirement, it's not necessarily time to stop taking a long view. After all, for more and more people – retirement is a period of life lasting 20-30 years, or even longer. But for those who will be actively living off their investments, it's a good time to start devising an allocation strategy that includes short-term, mid-term, and long-term investments. Once in retirement, a well-chosen investment allocation can provide you with peace of mind as you benefit from time in the market and maintain your income stream.

How to avoid falling into investing pitfalls

In the same way that I found myself acting against my better judgement ahead of the oncoming blizzard, avoiding common investing traps – like trying to time market movements, making emotional decisions, or paying too much attention to the news – is easier said than done. An investor's first step should be to ensure their portfolio is consistent with their preferences, time horizon, and appetite for risk. Additionally, investors will likely want to make sure their investments are appropriately diversified, which can help insulate their portfolio from extreme ups and downs of the market.

For some people, a financial advisor may be an important source of comfort and guidance, particularly in challenging market environments. Just as my wife reminded me that we were more than able to weather a storm, an advisor acts as a counselor through challenging times. Advisors can help investors identify solutions to fit their unique goals and can help clients avoid the behavior gap. Over time, this relationship can add real value – both measurable and immeasurable.

> *"I remember post-Lehman, there were arguments about whether or not to do the TARP program. On a Friday afternoon shortly after Congress had first turned it down, the whole market had fallen 10%. One of our longtime investors called us about 15 minutes before market-close and sold himself out of his entire stock fund position – which was a few hundred thousand dollars. On Monday, it became clear that Congress was going to pass TARP, and the market shot back up 10%. It was literally 15 minutes before market-close that Monday, the same investor called up and bought back in. So, he cost himself 10% of his entire account. Things like that make me sad. I try in my letters, I try in my annual meetings, I try when talking to clients – but people still make emotional investment decisions."*
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> *-Wally Weitz, CFA, Co-Chief Investment Officer*

Ultimately, there's no one-size-fits-all investing solution. Everyone's situation is different, and everyone has different goals. But those who can stay calm and allow the powers of reason to triumph over human behavior will find themselves on a much more comfortable, enjoyable financial journey.