Talking Investors Down Off The Ledge: How to respond to common investor behavior in times of market turbulence

By Scott Welch
Senior Managing Director, Investment Research & Strategy, Fortigent, LLC

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Introduction

In late 1776, as the American Colonists faced one of the toughest points in their struggle for independence, Thomas Paine famously reflected that “These are the times that try men’s souls.” The Colonists were losing most of the battles they fought, the soldiers were unpaid, disorganized, and starving, and the founding federal government was still powerless. At this point in time the overwhelming probability was that the British would crush the rebellion and restore colonial rule.

Paine went on to write in his pamphlets, “The summer soldier and the sunshine patriot may, in this crisis, shrink from the service of his country; but he that stands it now deserves the love and thanks of man and woman.”

Why the history lesson? For most investors the current market environment is, indeed, a time that is trying their souls. A global credit freeze, loss of confidence in the market itself, questions about the unprecedented degree of governmental intervention, and rampaging, seemingly out-of-control volatility are causing widespread panic, paralysis, and paranoia.

The result is somewhat inevitable (though not, I hasten to add, entirely rational) – markets around the world are falling precipitously. If greed (an extremely over-used word right now) was the catch-phrase for investor behavior of the past 3-5 years, its evil brother fear has taken over.

Many of our past stated concerns about the market are playing out – the consequences of the abuse of leverage primary among them¹. But you may also remember the investment philosophy we have consistently – and somewhat stubbornly – recommended for taxable high net worth investors:

- Broad diversification;

¹ Fortigent Research Report, Volume 2008, Issue 1: “…those that had incurred leverage are scrambling to deleverage, thereby driving asset values down, while those in a position to extend leverage are unwilling to do so, thereby freezing up the economy.”
• Maintenance of appropriate liquidity to meet investor objectives and cash flow requirements;
• Intelligent use of active and passive managers;
• Prudent use of non-traditional or alternative investments because of their diversification benefits;
• Discipline to an agreed-upon asset allocation and investment policy;
• Long-term investment discipline;
• Do not try to time the markets; and
• Pay close attention to fees and taxes – the only aspects of investment return that are remotely controllable.

Let’s face it – discipline to the above investment principles is very difficult in the current chaotic market. The natural human inclination is, as Peter Bernstein puts it\(^2\), to emulate the cockroach and run like hell at the first sign of danger. It works for the cockroach but it is a dangerous strategy for mammalian investors.

A Brief Summary of a Not-So-Brief Series of Unfortunate Events

The volume of articles and research discussing the causes of the current market conditions is overwhelming, and in talking to clients we should be cognizant of the fact that they are being fed a relatively non-stop stream of fear-inducing news about “corruption”, “greed”, “collapse”, “meltdown”, “credit crisis”, and “depression”. And that is just the rhetoric from the two men who want to be our President (how ironic that both feel they have to make things look as bad as possible in order to get elected!). Any good news or optimism that may exist is either not highlighted or is simply lost in the tidal wave of bad news.

In my opinion, there is no single root cause to current market turmoil. The old saying is that “Victory has a thousand fathers but defeat is an orphan.” But I think this current “defeat” has plenty of parentage, including:

• Misguided legislation that led to the over-promotion of home ownership (Community Reinvestment Act, among others);
• Misguided and special interest-influenced governmental intervention (Freddie and Fannie);
• Misguided Fed policy (keeping rates too low for too long);
• Misguided accounting rules that (1) encouraged the use of off-balance-sheet entities that allowed firms to hide the magnitude of the toxic assets on their books, and (2) forced quarterly mark-to-market write-down of illiquid (but not necessarily toxic) assets;

\(^2\) Heard from Peter Bernstein at numerous conferences, most recently at the CFA Institute’s Next Generation Asset Management conference in Washington, DC, on June 12th, 2008.
Antiquated, conflicted, and hopelessly out-of-their-league ratings agencies (which assigned AAA credit ratings to F- asset pools);

Antiquated and politically-influenced regulatory agencies;

Severe misuse and abuse of leverage (Derivatives, MBS, CDOs, Credit Default Swaps, 30:1 leverage ratios by large financial firms, etc.);

Risk management systems that inadequately captured non-traditional forms of risk (fat-tail events, liquidity, leverage, etc.);

Mortgage broker and borrower malfeasance (no-doc and liar loans); and let’s not forget

Greed – and not just on “Wall Street”.

I summarize these myriad culprits to the current situation not to point fingers but merely to highlight that this is a very complex situation and it will take complex solutions – and time – to work our way through it. Be very wary of anyone offering simple or one-off answers.

Common Investor Reactions to Chaos, and How to Combat Them

I alluded before to the “cockroach” theory of investor behavior – run like hell at the first sign of danger. But let’s look a little more closely at a few other very common reactions to extreme market environments.

Common Behavior #1: “You don’t understand – it’s different this time.”

It is very common to feel that the crisis you are in right now is biggest crisis ever. But whenever I hear the phrase “it’s different this time,” I think about the old line that if women accurately remembered the pain of childbirth, no one would ever have more than one. However bad things were in the past tends to fade and mellow with time, thereby heightening the seeming magnitude of the current crisis.

But if you are old enough to remember the oil embargo of the 1970s, “Black Monday” in the 1980s, the Savings & Loan, Long-Term Capital Management, the Asian/Russian collapses of the 1990s, the bursting of the Tech and Telecom bubbles in the early 2000s, and 9/11, then you know that things can look very bad when you are in the middle of them.

The interesting graph bellows shows the progress of the S&P 500 index over time, interspersed with icons of all that things that made us think the world was going to end – while we were going through them.
Investment Manager Jim O’Shaughnessy, in a recent investor presentation, offered some headlines through the ages, along with corresponding levels for the Dow Jones Industrial Index, which captures the fear and panic of the time:

- Wall Street Journal, June 9, 1939: “This is a Real Menace” (Dow: 140.09)
- New York Times, October 31, 1966: “Wall St. Remembers; No One Expects 1929 All Over Again, but Rates Surge, Scares Old-Timers” (Dow: 807.06)
- New York Times, March 23, 1970: “More Failures Portended as Wall Street Woes Rise; Closing of Another Big Brokerage House is Reported Near as Serious Financial Problems Face Many Other Firms.” (Dow: 763.59)
Isn’t it amazing what widening your personal “x-axis” – that is, lengthening your time horizon – can do? The point of the exercise is to encourage investors to lengthen their field of vision and focus on the long-term. There is no question that the current market environment is horrible. And yes, things are different this time – because things are different every time. But the global economy and the ingenuity of entrepreneurs and workers have always bounced back. I am not a
betting man but, if I was, my money would be on long-term investment success – if you don’t panic now.

Common Behavior #2: “I will get out now and come back in once it’s safe”

Behavioral Finance is the study of why generally rational investors so frequently make seemingly irrational decisions about their money. One concept within Behavioral Finance is known as the “gambler’s fallacy”. Think of someone playing blackjack in Las Vegas. How frequently might you overhear them say, “I’ll know when it’s time to get out”? And how frequently will they be wrong?

It is natural human behavior to possess this “gambler’s fallacy” – to have an exaggerated perceived ability to identify trends and predict turning points in those trends. The investment facts indicate otherwise. Consider the following chart, which compares domestic US equity returns against net new flows into mutual funds over the past ten years. What you see is an almost complete inverse relationship – investors tend to pile into the stock market just prior to a significant downturn, and pile out of the market just prior to an upswing.

Source: Davis Advisors Quarterly Review, Fall 2008

The result of this bad market timing is significantly deteriorated investment return. Consider the following graph, which illustrates the average stock fund return versus the average stock fund investor return over the past 20 years. The average investor’s marked inability to correctly time the market cost them roughly 7% per year in realized return.
Why the significant difference? In a market environment characterized by wild 5% - 10% swings on almost a daily basis, it might be hard to remember that, on most days in a normal environment, the stock market moves up or down less than 1%. But attempts to time the market are what drive the return differences illustrated in the above chart.

An analysis\(^3\) by Spanish academic Javier Estrada showed that for the period from 1900 – 2006, investors missing the best 10 days of (Dow) market performance generated portfolio returns 65% less valuable than a passive investment; avoiding the 10 worst days generated portfolio returns 206% more valuable than a passive investment. Estrada’s conclusion is very straight-forward: “Given that 10days represent 0.03% of the days in the sample, the odds against successful market timing are staggering.”

This notion is captured nicely in the following table prepared by TIAA-CREF, which draws from the Estrada analysis:

Davis Advisors illustrates similar results over the past 15 years:

Finally, the perceived ability to successfully time the market (versus the reality of failing miserably at doing so) was captured in the following graphic, which I received back in the early 2000s, when the tech and telecom bubbles were bursting (see, it really isn’t different this time):
Getting out now (the cockroach strategy) and then assuming you will know when it’s time to come back is – statistically speaking – a loser’s game. If your long-term investment objectives require you to be in the stock market, you are better off being in it through the ups and downs than by trying to jump in and out opportunistically.

This is why dollar-cost-averaging is such a good idea for so many people – it is, to a certain degree, a form of self-imposed trading discipline that mitigates the temptation to try and time investments into or withdrawals out of your portfolio.

Common Behavior #3: “I’ve reached my point of capitulation – just get me out!”

It is quite common, when markets get especially tough, for many investors to simply throw in the towel all together. Nothing like storing your money in nice safe, insured, bank CDs and Treasury bonds, right?

Unfortunately, no. While burying your money in a coffee can in the backyard feels safe, it ignores the insidious effect of inflation. The fact is that earning less on your money than the rate of inflation is the economic equivalent of incurring a
loss in the stock market. The result is the same – your money will purchase less in the future than it does today, as illustrated in the following chart.

The chart shows that an inflation rate of 4% per year will cut your purchasing power in half in only 15 years. No investor would accept a 50% loss on their stock portfolio over the same time frame, but somehow having inflation eat away at their money feels “safer” to many investors.

For a different example, consider the investor who is putting money aside for retirement. As the following chart illustrates, investing too conservatively (the gray lines represent portfolios that are 100% and 50% bonds) actually puts those retirement dollars more at risk (most of the time) than the “more risky” stock market (represented by the red – 100% stocks – line).
The other aspect to consider when investors feel the urge to capitulate is that it usually occurs at the absolute worst possible time – right at the point of locking in maximum loss.

Once again, we can look in our Behavioral Finance textbook and find an explanation for this behavior. The concept of “Prospect Theory” (a theory which earned its creators a Nobel Prize in Economics) says that humans dislike “pain” more than they enjoy “pleasure”. In investment terms, investors have an asymmetrical view of risk – they hate downside risk more than they enjoy upside reward. This is illustrated in the following graph:
Investors have an *asymmetrical* view of risk – bad outcomes produce more *pain* than good outcomes produce *pleasure*.

It is a highly understandable response to want to take flight and put your money in “safe” investments. But it is critical to remember that “risk” takes many forms – it is not simply the volatility of the stock market. Selling out at the bottom, missing part of any recovery from that bottom, and the loss of purchasing power because of inflation are also forms of risk that must be considered.

**Conclusion**

So what to do? Do the above arguments dictate that investors simply “hang in there” and wait for things to get better? Not at all – they simply illustrate that decisions should be made in as rational a manner as possible and with the long-term in mind.

What is a common sense course of action investors might take? Here are some ideas:
1. **Reevaluate your personal tolerance for risk.** Taking a page from prospect theory, many investors may determine that their appetite for risk – now that they are experiencing the downside part of the equation – is quite different (and quite lower) than they believed. If your time horizon or blood pressure do not allow you to endure volatile markets, then reallocate to a more conservative portfolio – keeping in mind that your portfolio needs to beat inflation to be successful over the long-term.

2. **Improve your liquidity profile.** Many of the asset strategies that have generated the best returns over the past few years have done so, at least in part, because they are less liquid (e.g., emerging markets, hedge funds, etc.). If you tie your assets up in less liquid markets you should expect a higher return for that illiquidity. If that trade-off is no longer worth it to you, then move to a more liquid portfolio.

3. **Improve your portfolio’s “time diversification”**. If there is a certain amount of money you know you will need over the next 2-3 years, or which you simply cannot tolerate losing, then by all means move that money to a shorter-term, more liquid, more conservative sub-portfolio.

4. **Take advantage of the market downturn to rebalance your portfolio.** Most markets, and therefore most portfolios, have performed strongly over the past 3-5 years. This translates into unrealized taxable gains – gains that may have partially or largely gone away in the recent market collapse. While most investors would rather have gains and owe taxes, this is now a good time to make any portfolio moves you were holding back on because of the associated tax hit. Associated with this is the strategy of harvesting any tax losses within the portfolio that you can use later to offset gains as the market recovers.

5. **Think opportunistically.** There are a lot of very smart investors (e.g., Warren Buffett) who believe this current market environment has created some unbelievable opportunities. No one is predicting when or where the bottom will be, but if you are comfortable potentially watching your investments go down in the short-medium term, you may be well rewarded in the long term. Conversely, if you remain bearish, there are plenty of very liquid ETFs and mutual funds that take “inverse” positions to the market – they go up when the market goes down. They are not for everyone and are probably not suitable as part of a long-term investment strategy. But if seeing something – anything – show up “green” after a market downturn makes you feel better and helps to immunize part of your portfolio, they might be worth considering.

6. **Don’t panic, stay disciplined and think long-term.** Cliché advice, I know. But it is a cliché because it is true. Whatever portfolio moves you decide to take, take them with the long-term in mind and in accordance with a well-thought out investment strategy and objective.
This is a terrible time in the market, and it naturally invokes anxiety and fear. I don’t know when it will get better, but I believe that, ultimately, it will. Markets have changed, paradigms have shifted, and portfolios are depressingly down. It is completely appropriate to rethink your actual tolerance for risk and adjust your portfolios accordingly.

These are, indeed, times that try men’s souls. But to paraphrase Thomas Paine, fear-induced “summer” investors and “sunshine” investment strategies will, in this crisis, shrink away from success.

The keys to long-term investment success have not changed – be diversified, manage liquidity wisely, think long-term, and stay disciplined. Investors who adhere to this investment approach will live to fight another day, and will earn “the love and thanks of man and woman.”

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