Impediments to successful investing

Emotional bias, distracting sales stories, and rearview mirror focus

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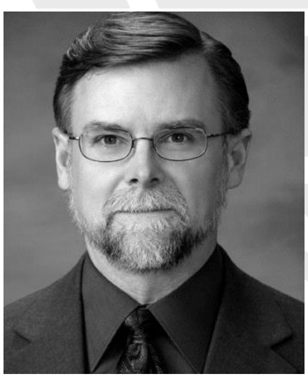

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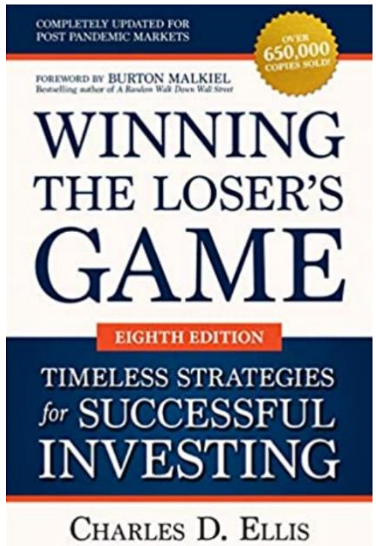
Impediments to successful investing

If you only have the time for a single investment book, the best read is *"Winning the Losers Game,"* by Charles Ellis, with a forward by Burton Malkiel. This book has been so successful, that it's now in the eighth edition.



Here's a selection of Charlie's more pithy observations:

> *For all its amazing complexity, the field of investment management really has only two major parts. One is the profession - doing what is best for investment clients - and the other is the business - doing what is best for investment managers. As in other professions, such as law, medicine, architecture, and management consulting, there is a continuing struggle between the values of the profession and the economics of the business. Investment firms must be successful at both to retain the trust of clients and to maintain a viable business, and in the long run, the latter depends on the former. Investment management differs from many other professions in one most unfortunate way: it is losing the struggle to put professional values and responsibilities first and business objectives second.*
>
> *Over the past 20 years, more than four out of five of the pros got beaten by the market averages. For individuals, the grim reality is far worse.*
>
> *Of course, most professional investment managers would have good performance - comfortably better than the market averages - if they could eliminate a few "disappointing" investments or a few "difficult" periods in the market. (And most teenagers would have fine driving records if they could expunge a few "surprises.")*

Investing is not entertainment - it's a responsibility - and investing is not supposed to be fun or "interesting."

Benign neglect is, for most investors, the secret of long-term success . . . The hardest work in investing is not intellectual; it's emotional . . . The hardest work is not figuring out the optimal investment policy; it's sustaining a long-term focus - particularly at market highs or market lows - and staying committed to your optimal investment policy.

A small boat sailor can do little to change the wind or tide but can do a lot by selecting the right course, keeping sales well-trimmed and by knowing what he and his boat can do in heavy weather and watching for the signs to avoid serious storms. Similarly, the investor can work with the markets to achieve his or her realistic objectives, but must not take on more risk of heavy weather or possible market movements beyond his capacity to sustain commitments until the market storms have passed.

While investment counseling is more important to long-term success than managing investment portfolios - and could make far more of an economic difference over the long term - most investors will neither do the disciplined work of formulating sound long-term investment policies for themselves nor pay the modest fees for investment counseling - the more important service.

For most investment managers, portfolio management is neither an art nor a science. It is instead an unusual problem in engineering, determining the most reliable and efficient way to reach a specified goal, given a set of policy constraints, and working within a remarkably uncertain, probabilistic, and always changing world of partial information and misinformation, all filtered through the inexact screen of human interpretation.

Don't get confused about stockbrokers and mutual fund salespeople. They are usually very nice people, but their job is not to make money for you. Their job is to make money from you.

During the last ten years, professional money management has become a Loser's Game - i.e., a game one wins by avoiding mistakes rather than by positive achievement. As in other Loser's Games, those players who assume they are playing a Winner's Game meet only with frustration. Drawing examples from tennis, golf, and war, the author offers advice on how to win the money game.

Ellis observes that all games are of one of two types, winner's games and loser's games. In a winner's game, the outcome is determined by the correct actions of the winner. In contrast, in a loser's game, the outcome is determined by mistakes made by the loser. Charlie spends most of the book explaining how and why investing is a loser's game . . . one wins by avoiding making mistakes.

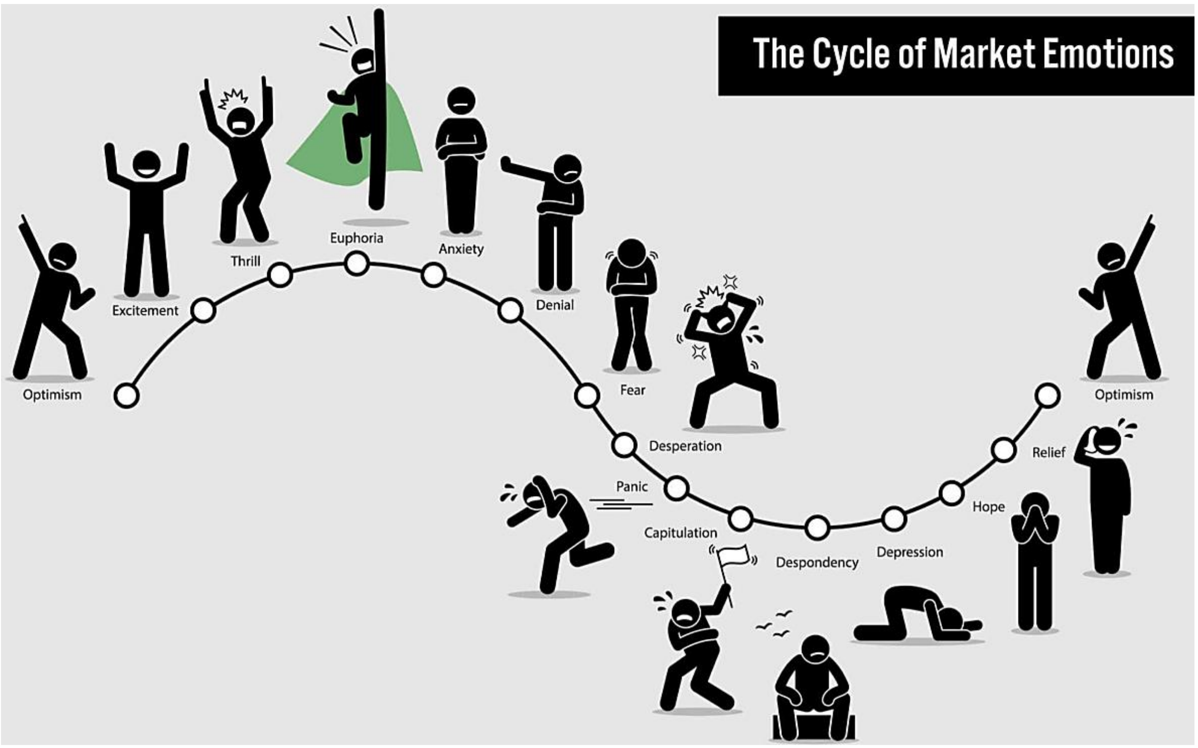
Three of the most powerful avoidable mistakes include:

- Emotional bias,
- Falling prey to distracting sales practices, and
- Basing one's investment decisions on a rearview mirror focus.

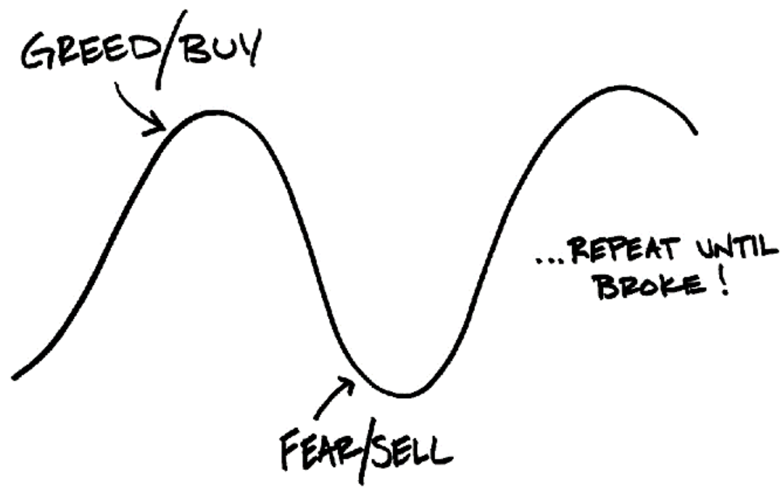
We cover each of these mistakes in turn.

Emotional bias

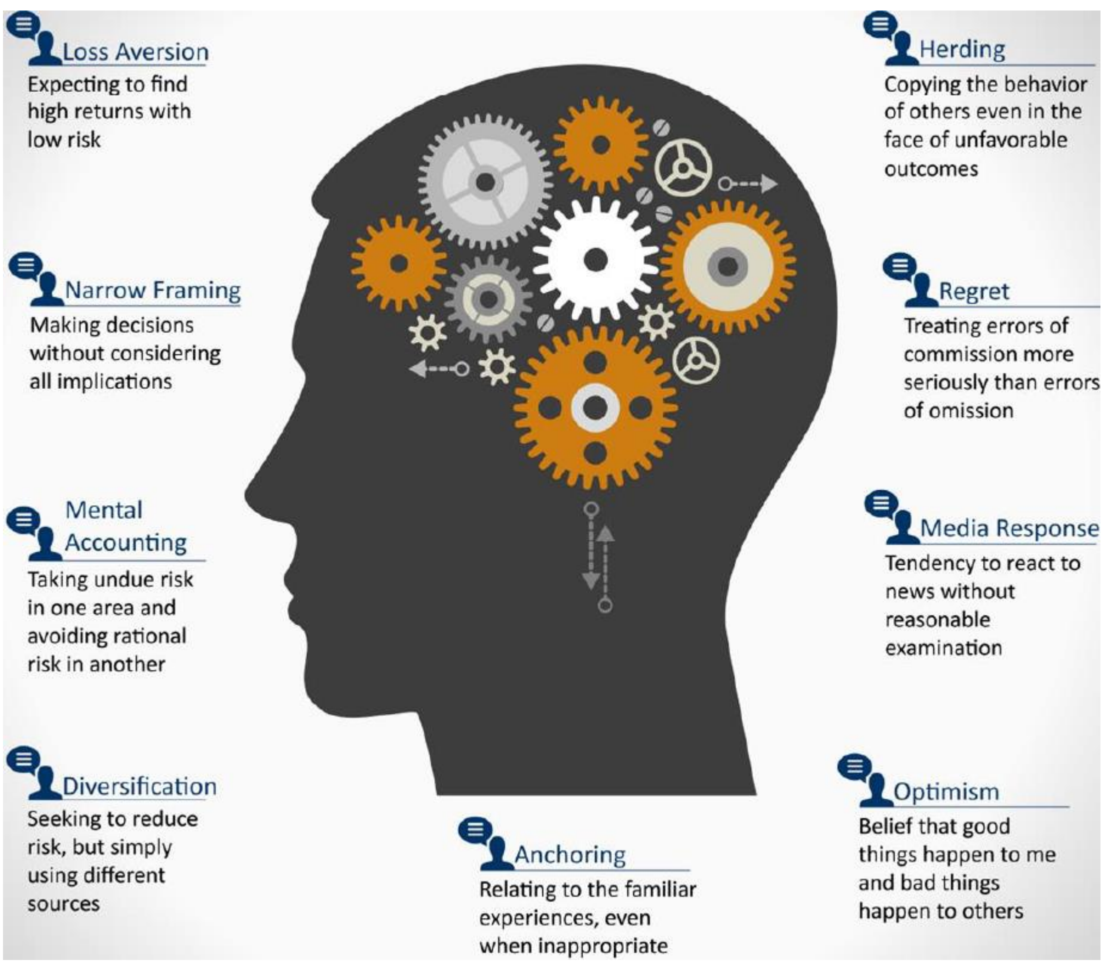
When we allow emotion to affect our investment decision-making, the results are universally disastrous. As markets appreciate, we become optimistic. After markets have set new highs (are expensive and over-priced) we become euphoric and add to our positions. As markets decline, we become fearful. Once markets have set new lows, our fear turns to despondency and capitulation. At this point, we sell out of the market, serving to lock in our loses.



The continued cycling between fear and greed and the consequent buying-high and subsequent selling-low, inevitably ends in tragedy as exemplified by the following graphic.



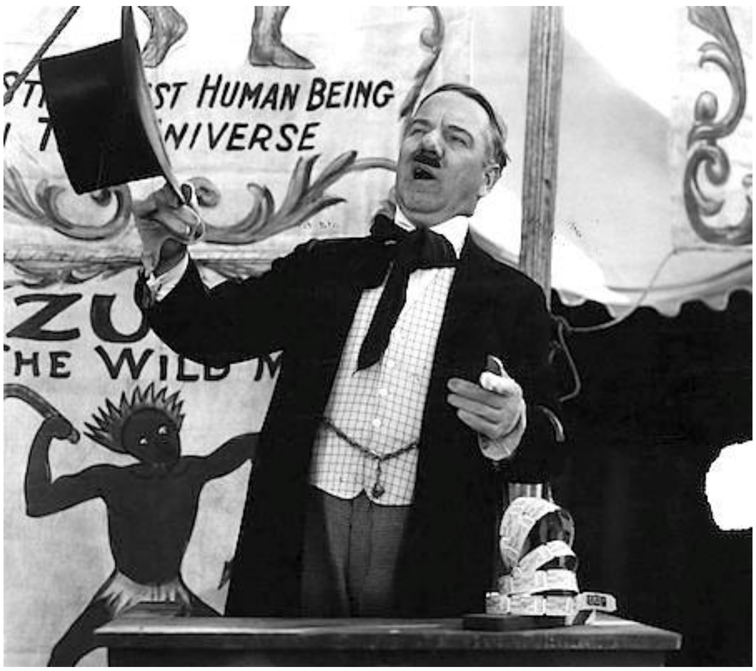
But our investment decision-making processes are challenged by far more than simple emotional bias. Many behavioral attributes serve to undermine constructive investment decisions. The following exhibit identifies nine additional challenges that inevitably undermine our results.



Falling prey to distracting sales practices

Experienced effective sales people appreciate that emotions such as fear, greed, hope, and denial are some of the most powerful behavioral motivations. As a consequence, they are often used to motivate a specific investment decision, buy this or sell that. At times, this appeal to emotion is further compounded by empty storytelling. Such stories attempt to imply that a particular investment has more substance and veracity than is actually the case.

Being forewarned is being forearmed. By being aware of the occasional distracting sales practice we can immunize ourselves against it. For example, just because an investment portfolio delivered superior investment performance over the past 1-, 3-, 5-, and 7-years means absolutely nothing for its future performance. In fact, history shows that such past out-performers are more likely to under-perform in the future.



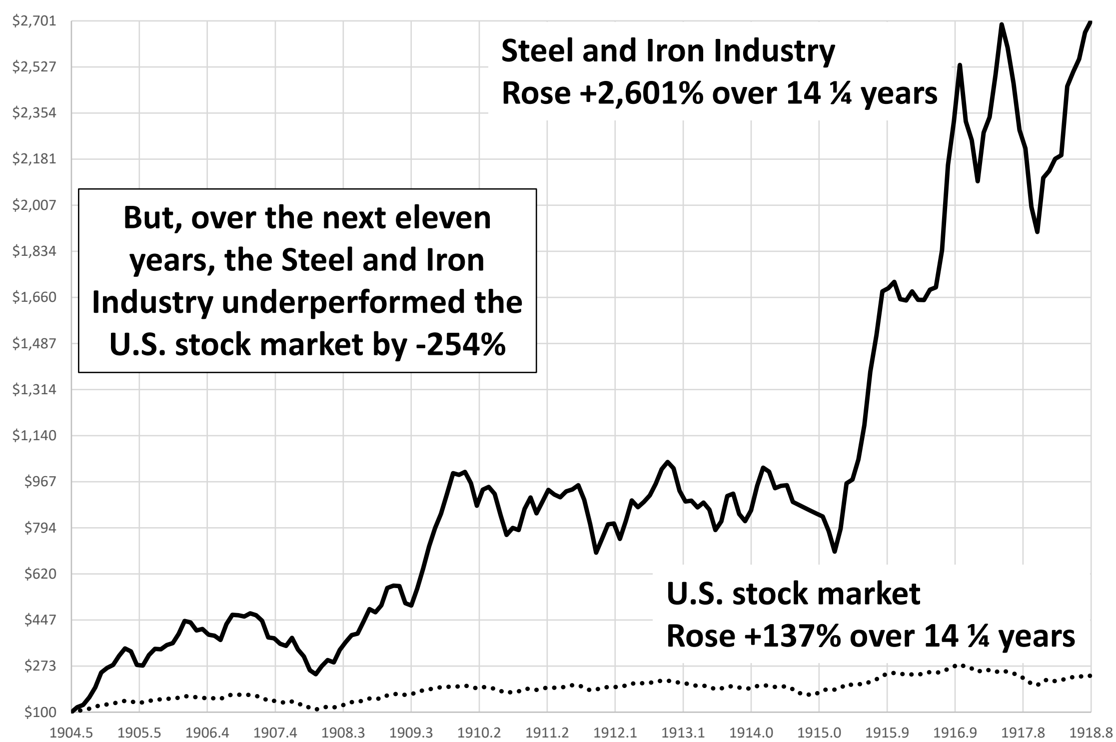
Basing one's investment decisions on a rearview mirror focus

The last of the three most powerful avoidable mistakes is that of basing one's investment decisions on past returns - or sometimes called "rearview mirror investing." The mistake is to look at the past and draw the false conclusion that the past will continue into the future, good returns will continue to be good and bad returns will continue to be bad. Neither of which is true.

Consider for a moment the current ongoing technology and innovation boom. Some investors mistakenly believe that past outperformance of technology and innovation companies will continue into the future. But this is just not the case and never has been.

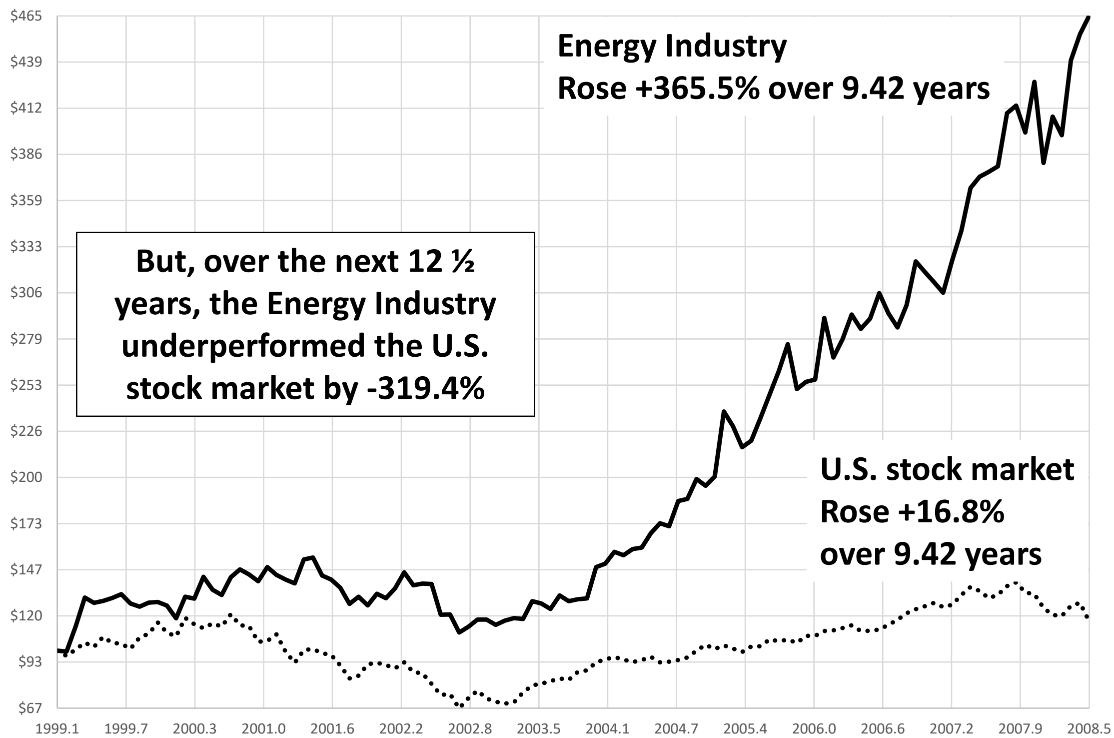
Technology and innovation are nothing new. For over 300 years every major industrialized nation has created entirely new industries through a process of profound technological evolution and innovation. Each time, these cycles have followed the same pattern of boom followed by bust. The only variation has been in the duration and severity of the cycles.

The creation of the American steel and iron industry provides a classic example. Starting shortly after the turn of the century, steel and iron stocks took off, delivering a return of over 2600% in a little over 14 years. During this same period, the board-based U.S. stock market generated a far more modest return of just 137%. But then bust ensued and steel stocks underperformed the general stock market by -254%



A more recent example of this same technology/innovation driven boom and bust cycle is provided by the American energy industry starting in the late 1990s. It was during this period that powerful innovations developed within highly sophisticated hydrocarbon recovery techniques. These new technologies allowed previously non-economic energy reserves to become highly productive and quite profitable. Application of these new technologies allowed the U.S. to move from energy importer to one of the world's most important energy exporters.

Just as with the steel and iron industry, energy stocks skyrocketed. Over a short number of years, energy returned 365.5% while at the same time the broad-based U.S. stock market was essentially flat (delivering a miserly 16.8%). But once again, boom turned to bust. Over the subsequent years, energy underperformed the general stock market by -319.4%.



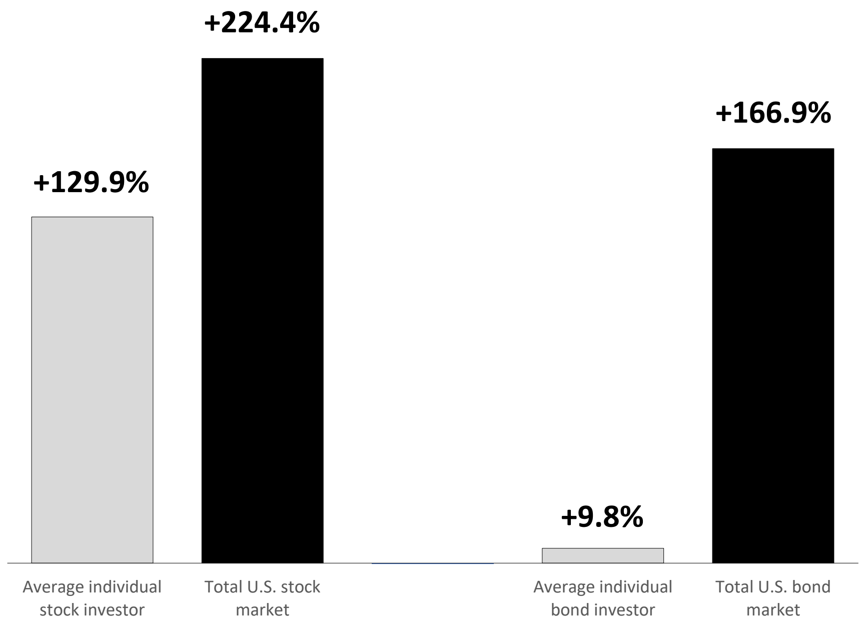
Investors who made their investment decisions on past returns (rearview mirror investing) bought in after prices had risen and stocks had become expensive. They subsequently road their investment down, selling out of their positions at a loss.

As a general rule (but by no means consistent), last year's winners are frequently next year's losers - and vice versa. The graphic below shows the power of this reversal pattern, i.e., winners turning into losers and losers into winners. This chart identifies ten of the most popular and commonly used asset categories. It ranks these ten in order of return, with the highest returning at the top (for each year) and the lowest returning at the bottom. Notice how the best performing asset category for 1999 (MSCI Emerging Markets) became the worst performing in 2000. Similarly, the worst performing in 1999 (Russell 2000 Value) became the best performing in 2000.

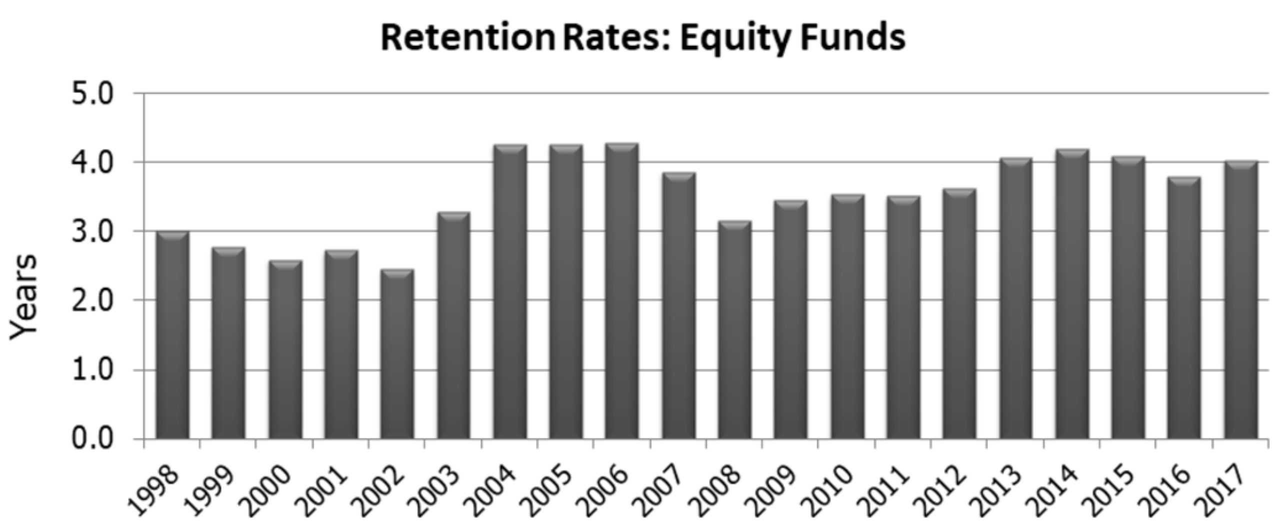
1999	2000	2002	2003	2007	2008	2011	2012	2015	2016
MSCI Emerging Markets 66.8%	**Russell 2000 Value 22.8%**	**Bloomberg Barclays Aggregate 10.3%**	MSCI Emerging Markets 55.8%	**MSCI Emerging Markets 39.4%**	Bloomberg Barclays Aggregate 5.2%	**Bloomberg Barclays Aggregate 7.8%**	**MSCI Emerging Markets 18.2%**	**S&P 500 Growth 5.5%**	**Russell 2000 Value 31.7%**
Russell 2000 Growth 43.1%	Bloomberg Barclays Aggregate 11.6%	Bloomberg Barclays High Yield -1.4%	**Russell 2000 Growth 48.5%**	MSCI World ex USA Stocks 12.4%	Bloomberg Barclays High Yield -26.2%	Bloomberg Barclays High Yield 5.0%	Russell 2000 Value 18.1%	S&P 500 LargeCap 1.4%	Russell 2000 SmallCap 21.3%
S&P 500 Growth 28.2%	S&P 500 Value 6.1%	MSCI Emerging Markets -6.2%	Russell 2000 SmallCap 47.3%	S&P 500 Growth 9.1%	**Russell 2000 Value -28.9%**	S&P 500 Growth 4.7%	S&P 500 Value 17.7%	Bloomberg Barclays Aggregate 0.6%	S&P 500 Value 17.4%
MSCI World ex USA Stocks 27.9%	Russell 2000 SmallCap -3.0%	Russell 2000 Value -11.4%	Russell 2000 Value 46.0%	Russell 2000 Growth 7.1%	Russell 2000 SmallCap -33.8%	S&P 500 LargeCap 2.1%	Russell 2000 SmallCap 16.4%	Russell 2000 Growth -1.4%	Bloomberg Barclays High Yield 17.1%
Russell 2000 SmallCap 21.3%	Bloomberg Barclays High Yield -5.9%	MSCI World ex USA Stocks -15.8%	MSCI World ex USA Stocks 39.4%	Bloomberg Barclays Aggregate 7.0%	S&P 500 Growth -34.9%	S&P 500 Value -0.5%	MSCI World ex USA Stocks 16.4%	MSCI World ex USA Stocks -3.0%	S&P 500 LargeCap 12.0%
S&P 500 LargeCap 21.0%	S&P 500 LargeCap -9.1%	Russell 2000 SmallCap -20.5%	S&P 500 Value 31.8%	S&P 500 LargeCap 5.5%	S&P 500 LargeCap -37.0%	Russell 2000 Growth -2.9%	S&P 500 LargeCap 16.0%	S&P 500 Value -3.1%	Russell 2000 Growth 11.3%
S&P 500 Value 12.7%	MSCI World ex USA Stocks -13.4%	S&P 500 Value -20.9%	Bloomberg Barclays High Yield 29.0%	S&P 500 Value 2.0%	Russell 2000 Growth -38.5%	Russell 2000 SmallCap -4.2%	Bloomberg Barclays High Yield 15.8%	Russell 2000 SmallCap -4.4%	MSCI Emerging Markets 11.2%
Bloomberg Barclays High Yield 2.4%	S&P 500 Growth -22.1%	S&P 500 LargeCap -22.1%	S&P 500 LargeCap 28.7%	Bloomberg Barclays High Yield 1.9%	S&P 500 Value -39.2%	Russell 2000 Value -5.5%	S&P 500 Growth 14.6%	Bloomberg Barclays High Yield -4.5%	**S&P 500 Growth 6.9%**
Bloomberg Barclays Aggregate -0.8%	Russell 2000 Growth -22.4%	S&P 500 Growth -23.6%	S&P 500 Growth 25.7%	Russell 2000 SmallCap -1.6%	MSCI World ex USA Stocks -43.6%	MSCI World ex USA Stocks -12.2%	Russell 2000 Growth 14.6%	**Russell 2000 Value -7.5%**	MSCI World ex USA Stocks 2.8%
Russell 2000 Value -1.5%	**MSCI Emerging Markets -30.7%**	**Russell 2000 Growth -30.3%**	**Bloomberg Barclays Aggregate 4.1%**	**Russell 2000 Value -9.8%**	**MSCI Emerging Markets -53.3%**	**MSCI Emerging Markets -18.4%**	**Bloomberg Barclays Aggregate 4.2%**	MSCI Emerging Markets -14.9%	Bloomberg Barclays Aggregate 2.7%

The terrible tendency for investors to base their investment decisions on past returns, and to therefore buy high and sell low, is studied each year by DALBAR. For over 30 years, DALBAR has calculated how individual investors have performed versus if they had just left their money invested, essentially untouched. The results of the DALBAR's 2020 study are shown below. This graph shows how the average individual stock investor did over the last 20 years, earning 129.9% on their original investment, on average. However, if they had just purchased the board-based U.S. stock market and left their investment alone, they would have earned a higher 224.4%

A similar but even more extreme result was experienced by the average individual bond investor. Over the last 20 years, the average bond investor earned just 9.8% (a cumulative return over the entire 20 year period). In contrast, if they had just invested in the broad-based U.S. bond market and left their investment alone, they would have earned a higher 166.9%.



Just how common and extensive the problem of rearview mirror investing has become is best demonstrated by the next chart. This graph shows the average number of years that the typical investor holds a mutual fund investing in stocks. In 2017, the number was just 4.0 years. Over the last 20 years, the average holding period has ranged from a low of 2.4 years to a high of 4.2 years. The takeaway is that the average investor is continually churning their investment account as they attempt to chase past performance, serving to perpetuate their endless pattern of buying-high and selling-low.



Important disclosures

Data Sources:

- All data and statistics for the graph on the Steel and Iron industry were provided by Global Financial Data, Inc. on January 19, 2021. Steel and Iron Industry measured by the Cowles Steel and Iron Return Total Return Index. U.S. stock market measured by the S&P 500 Total Return Index. Data provided by Global Financial Data, Inc. at https://finaeon.globalfinancialdata.com
- All data and statistics for the graph on the Energy industry were provided by Global Financial Data, Inc. on January 19, 2021. Energy Industry measured by the S&P 500 Energy Total Return Index 10. U.S. stock market measured by the S&P 500 Total Return Index. Data provided by Global Financial Data, Inc. at https://finaeon.globalfinancialdata.com
- All data and statistics for the ten asset categories and their respective returns each calendar year were provided by Global Financial Data, Inc.
- Data and statistics for how the average individual stock and bond investor performed over the last 20 years was provided by The Capital Group Companies, Inc. in their publication Lit. No. INGEFL-050-0420P Printed in USA CGD/TM/9907-S76736. The Capital Group relies on the 2020 DALBAR study for their performance for individual investors. The use the S&P 500 Index to represent the broad-based U.S. stock market and the Bloomberg Aggregate Bond Index to represent the board-based U.S. bond market.
- The statistics for the graph entitled “Retention Rates: Equity Funds” comes from the 2018 DALBAR QAIB Report entitled “Quantitative Analysis of Investor Behavior”

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