

When the going gets tough, investors panic



If you have been listening to me talk or reading my periodic articles and web site then by now you have learned how:

- **taxation** and **inflation** act to destroy wealth
- long term **fixed income** investing is financial suicide because such investments are measured in dollars, which themselves are devalued by inflation
- **equity** investing, though variable, leads to inflation protection and capital building because equities are the original source of wealth creation and all other investments are a reduced residual of equities
- **diversification** avoids the risk of large permanent losses.

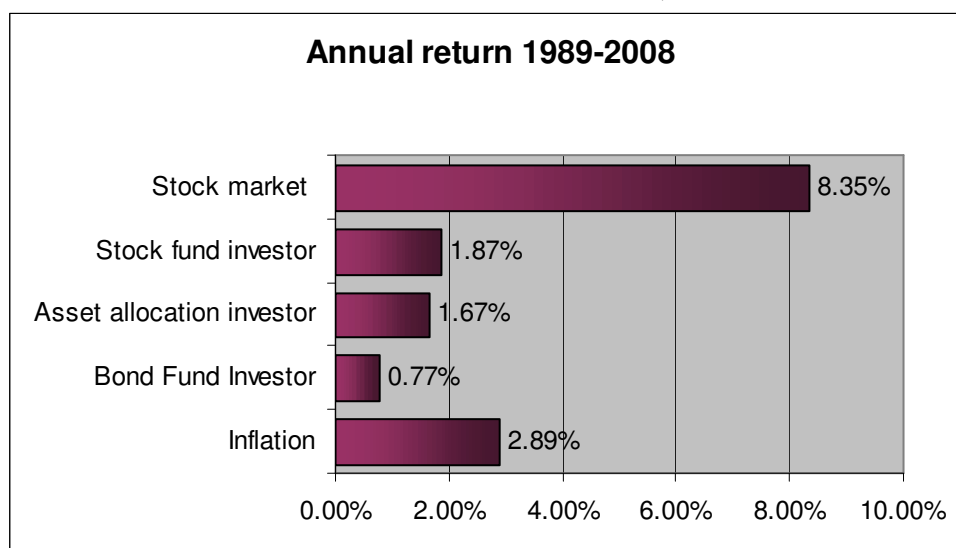
Okay, so financial success sounds simple - just invest in a diverse pool of equities and give them time to perform. Simple, yes. Easy - not at all. If it was that easy everyone would do it. In fact, the wealth creating power of equities and the variability of returns are inextricably linked – you can't have the rewards of equities without the variability. As we constantly see and hear in the media, investors have a strong tendency to react to news and adjust their investment portfolios. Have you ever wondered if they are well served by their reactions and portfolio changes? Well, one research company has been doing exactly that for many years.

For 15 years Dalbar Inc.'s Quantitative Analysis of Investment Behavior (QAIB) has been measuring the effects of investor decisions to buy, sell and switch into and out of mutual funds in the United States. They use aggregate data from the Investment Company Institute that tracks money flows into and out of mutual funds, combined with monthly performance. In this way they simulate the results of the average investor. This data is then compared to investment market indices. Data in this article is drawn from their 2008 iteration of the QAIB study.

Chart 1 below shows the annual returns from 1989-2008 for the U.S. stock market as measured by the S&P500 Index, inflation as measured by the Consumer Price Index and three investor categories as measured by Dalbar Inc. in the fashion previously discussed. The stock market has averaged 8.35% for this 20-year period. While this is a couple of percent below its longer term average because it includes the two very large declines of 2000-2002 and 2007-2009, it is still a good result. We would expect the average investor to achieve similar results, minus the costs of investing.

Instead, when Dalbar Inc. examines the results of the average individual mutual fund investor, measuring the actual dollar gains inside investors' accounts to see what they actually accomplished after all switching and market timing decisions, they find that investors earned less than one quarter of the returns offered by the market. Stock fund investors earned only 1.87%, asset allocation investors earned 1.67% and bond fund investors earned 0.77%. Indeed, when the most recent ten year period was examined all three types of investors had negative returns. This is not simply because the investments were poor, but rather the behavior of the investors was poor. Investors attempted market timing and fund switching to increase returns but actually accomplished the opposite and missed out on the gains. Even those with advisors of some kind fared much worse than the market.

Chart 1: Annual returns from 1989-2008 for the U.S. stock market, inflation and investors

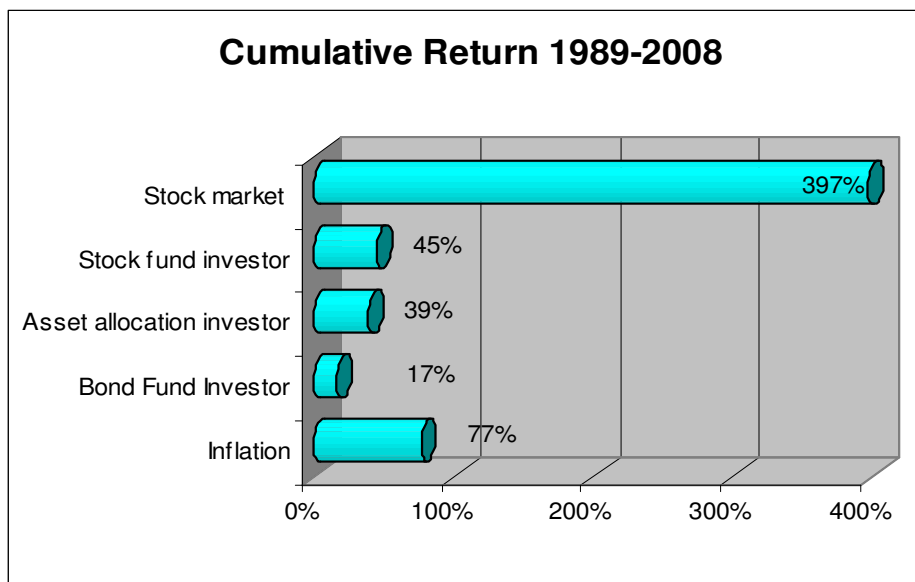


What is happening in the minds of investors to cause these large discrepancies between market returns and investor results? In short, when the going gets tough, investors panic. The last two years have provided a textbook case of this. The year 2006 provided some great investment results and many investors were lured into the story of natural resources, commodities, real estate and alternative investments because they had done so well over the previous three to five years. Oil prices surged to record highs. Real estate values soared as interest rates were kept low and lending practices were distorted by government policies. Then, in the span of a year and a half, the equity market price dropped 56% and oil prices fell about 80%. In March of this year, the cash balances in money market funds and bank savings accounts exceeded, however briefly, the capitalization of the entire U.S. equity market, as denominated in the Wilshire 5000 Index.

Who saw this coming? In a Wall Street Journal article earlier this year a researcher reported on the forecasting accuracy of 51 top economists for the year 2008 for two data points: real GDP growth the unemployment rate at the end of 2008. There were thus 102 forecasts. Of these, 101 were wrong in the same direction. One economist, for one of his two forecasts, was right. This highlights the essential futility of using short term economic forecasting to guide your investment decisions. Even if some of them were right this time, what are the odds they would keep getting it right in the future? That's correct; the odds are next to nothing. What do the media report breathlessly on a day-to-day and even minute-to-minute basis? That's right; short-term economic data. How useful is it to read the financial section of last week's newspaper? How much would anyone pay for information from that paper?

The cumulative damage done by the emotional behavior of individual investors is staggering. Look at Chart 2, showing the cumulative returns corresponding to the annual returns from Chart 1. Over 20 years the stock market has risen 397% while in the same period stock fund investors managed only a 45% gain. Investors missed out on essentially all of the gains because they behaved badly. They could have achieved much better results by throwing darts at a list of stock funds and leaving them alone for 20 years. This is a perfect illustration of the truth in the financial advice adage "***Don't do something, just stand there***"! Yes, it turns out that once your strategic asset allocation based on your goals and financial resources has been done, the best way to manage your portfolio is to *just stand there*.

Chart 2: Cumulative returns from 1989-2008 for the U.S. stock market, inflation and investors



Just standing there is absolutely not an easy thing to do – in fact it is very difficult as evidenced by the small number of individuals who are able to accomplish it. It is quite easy to get invested but very hard to hang on to good investments when the media is screaming “**SELL or BUY – DO SOMETHING!**” A caring financial planner helps you invest in a diverse pool of global equities and is extremely cautious about switching them around or trying to time the markets. In my 16 years as an advisor I have sometimes been guilty of being an enabler – letting the emotionally-driven concerns of clients lead them to make expensive mistakes.

Accordingly, I have refined and simplified my investment philosophy to a simple approach using mostly a handful of global equity funds managed by disciplined and experienced managers who understand true value investing. Making a change to any of these would be a big deal for me as I would have to be very sure a lasting and meaningful negative change has taken place in their money management methods. A decision of this type usually takes years. Periods of high market fluctuations such as the last ten years provide a good time to examine money managers to determine if they have an effective and disciplined investment strategy. I have done this examining and found a few funds owned by clients to be not as good as I had originally believed but even in these cases a quick change is not necessary since their future is not knowable and this change is not as important as being in the right asset class.

In summary, the emotional response of individual investors leads the average person to achieve results far lower than the potential offered by the investment market. Investors are their own worst enemies: “I have met the enemy and he is me”. Understanding this, it is the calling of the caring behavioral investment counselor to help clients first make good asset allocation decisions and then (and infinitely more difficult) to stick to the original plan.

“Fear has a greater grasp on human action than does the impressive weight of historical evidence.”
- Prof. Jeremy Siegel

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