November 2005 Commentary

MADISON FINANCIAL ADVISORS

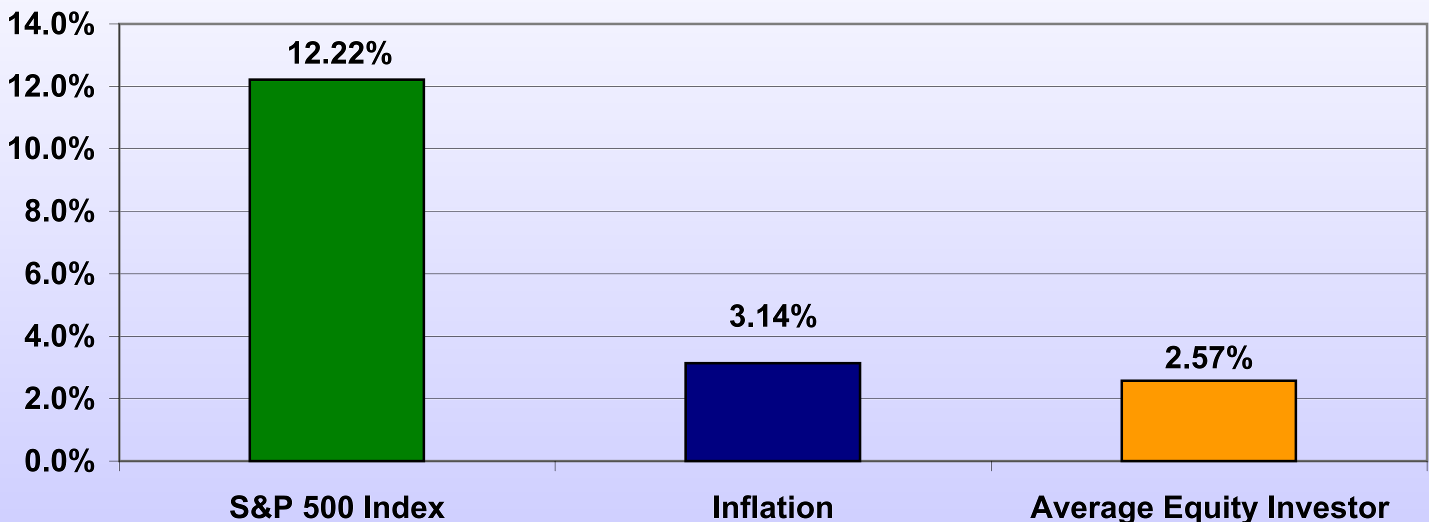
Investor Return = Investor Behavior * Investment Results

Investing is all about making decisions and wise choices. Yet many investors give little or no thought as to how they actually make decisions. Most investors emphasize the “Investment Results” part of the above equation, focusing on buying and selling stocks and mutual funds without considering how their behavior is influencing the outcome. The “Investor Behavior” part of the equation, however, is the only part that they can control. Because investors cannot control what happens in the financial markets, those investors who desire better results ought to examine their own behavior.

In a study published in 2003, the financial services research firm, DALBAR Inc., showed that investors chase investment returns to the detriment of their pocket books. To arrive at this conclusion they calculated a dollar-weighted return, rather than just examining total returns, which shows how a fund has performed over time. Dollar-weighted returns indicate how well investors timed their purchases and sales.

According to the study, “(m)otivated by fear and greed, investors pour money into equity funds on market upswings and are quick to sell on downturns. Most investors are unable to profitably time the market and are left with equity fund returns lower than inflation. The average equity investor earned a paltry 2.57% annually; compared to inflation of 3.14% and the 12.22% the S&P 500 index earned annually for the last 19 years.” The poor performance results weren’t just limited to equity investors for the study also found that “the average fixed income investor earned 4.24% annually; compared to the long-term government bond index of 11.70%.” While these benchmarks may not be entirely appropriate for the average investor and not all investors desire to meet or beat these particular market benchmarks, these investor returns are stunningly low!

"**Where we have strong emotions, we're liable to fool ourselves**." - Carl Sagan



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"**A committee can make a decision that is dumber than any of its members.**" - David Coblitz

And it's not just individual investors that seem to make poor timing decisions. In a study of institutional clients, a prominent consulting firm found that when their clients replaced an investment manager for poor performance, the new manager underperformed the fired manager about two-thirds of the time over the following three-year period. This is interesting because even managers that post investment results that place them in the top quartile (top 25%) over a ten-year period, will have periods of underperformance during that ten-year period. A recent study of such managers found that there was about a 94% probability that a manager will post results in the bottom 50% over a three-year period sometime during the ten-year period of top quartile performance.

Unfortunately, most investors find it challenging to stick with a manager during a challenging period, even though studies consistently show that past performance (good or bad) isn't all that predictive of future performance. In reality, it can take a very long time to statistically prove that a manager's performance record is not just due to good (or bad) luck. The problem likely stems from our lack of appreciation of the level of uncertainty and the central role that uncertainty plays in just about everything related to investing.

Understanding the role of psychology in decision-making may help us go a long way in improving our decision-making skills. For instance, realizing that emotions impact our decision-making abilities may help us avoid some mistakes. Research shows that we tend to trust our initial emotional reaction and only correct that initial view occasionally and with great effort. Thus, a negative initial emotional response may lead to making a poor decision.

Emotion, however, can both help and hinder us. Without emotion we are unable to sense risk; with emotion we can't control the fear that risk generates. Also, research in this area shows that people are very bad at projecting how they will feel under the influence of emotion. The problem for investors is that when we are relaxed and emotion free, we underestimate how we might act under a period of emotional distress such as a financial market crash. If our self-esteem is threatened, we can become upset and lose our capacity to act rationally. Thus, when these events occur we are completely unprepared to deal with the fear and feelings of panic. What's more, each time we fight the urge to sell and get out of the market, our ability to exercise such self-control in the future diminishes. By the way, some of the most successful investors, like Warren Buffett, love market crashes as it offers them a chance to make investments at very attractive prices. These investors have learned to overcome their emotional responses to these type of events.

Psychologists have spent years documenting the types of behaviors to which we are prone (e.g., self-deception, over-optimism, over-confidence, hindsight bias, framing, anchoring, regret, herding…). Unfortunately space is too short here for a discussion of them, but perhaps in a future Commentary. The good news is that we are capable of generating new brain cells pretty much over our lifetime and the brain isn't fixed into a certain format. Over time we can rearrange the pathways in our brains for better decision-making. If we can get into good mental habits, they can become persistent. The first step down this path is becoming aware of the fact that we are all likely to suffer from what psychologists call heuristics (rules of thumb) and biases. Suffice it to say that there is hope for investors, with a little bit of effort, to increase their "Investor Return" by improving their "Investor Behavior."

"**What we know about the future is tiny compared to what we do not know and in all likelihood cannot know**." - Mark Finn

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