INVESTOR BEHAVIOR

From 'tulipmania' in the 1630s to the dotcom bubble that straddled the end of the last century, history is littered with examples of irrational investor behaviour. The good news is that it is possible to minimize the damage caused by such behaviours.

Take the emotion out of investing

There is an abundance of research that shows that investors' emotions and behaviour are a major determining factor in their long-term portfolio performance. The average investor underperforms the market over long periods of time by a wide margin. Carl Richards refers to this as the "behaviour gap," which is the difference between the higher investment returns investors can possibly earn, versus the lower returns they earn due to their emotional behaviour in responding to whatever is happening in the markets; volatility being the leading culprit.

This insight was prompted by research conducted by Dalbar, which for the last 25 years has measured the effects of investor decisions to buy, sell and switch into and out of mutual funds over short-and long-term timeframes. The results consistently show that the average investor earns less – in many cases, much less – than mutual fund performance reports would suggest.

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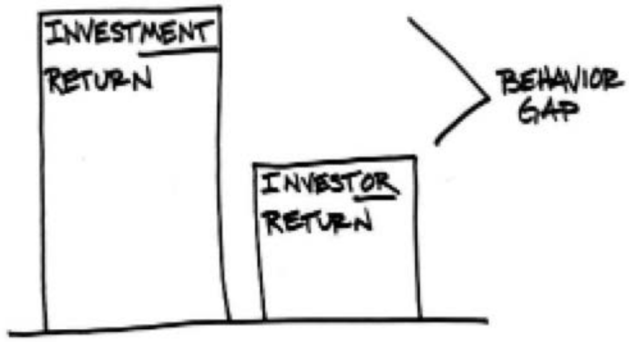
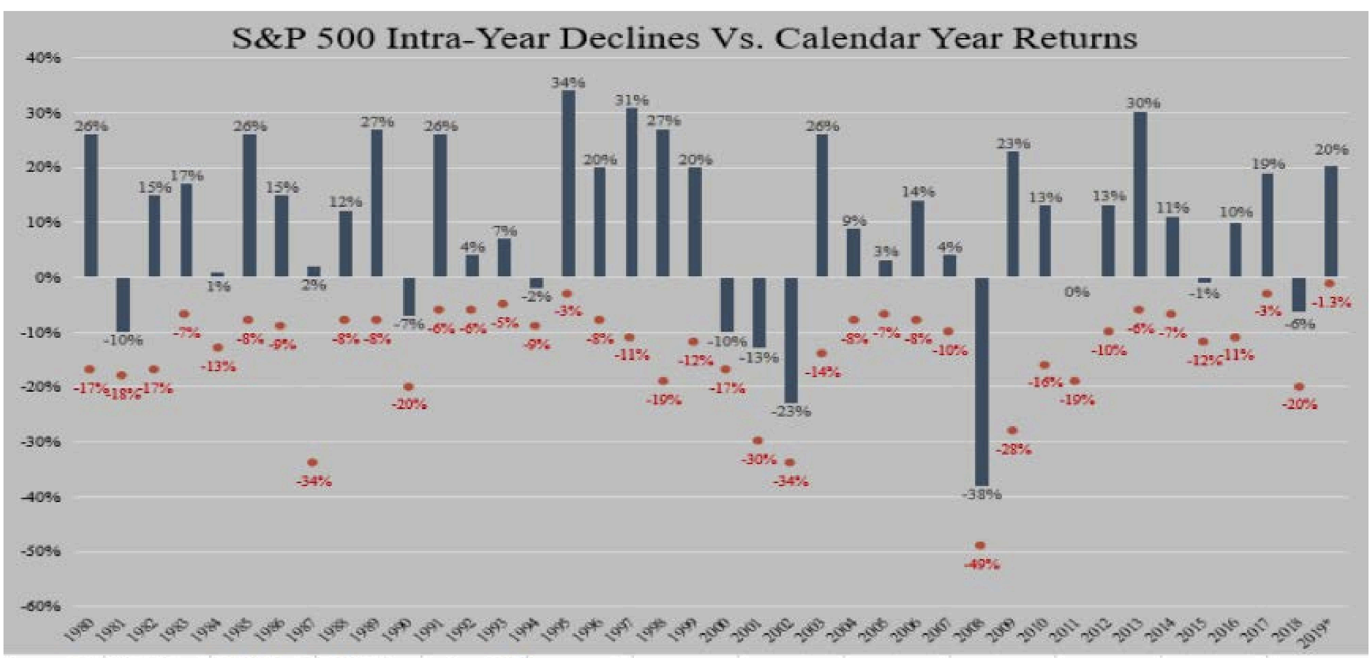


For example, since 1988 the S&P 500's average annual return has been 10%, yet stock fund investors have earned only 4.1% per year over than time. Similarly, while Fidelity Investments' Magellan Fund returned an average of 29% over the period 1977-1990 compared to 15.52% for the S&P 500, the average investor in the fund managed to lose money. The dangers of selling during under-performance and chasing winners is underscored by this chart of S&P 500 annual return and intra-year declines since 1980.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management
Returns are based on price index only and do not include dividends. Intra-year drops refer to the largest market drops from a peak to trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 - 2018, over which time period the average annual return was 9.61% and 11.18% from 2009 -2018. Average drawdown from 1980 - 2018 was 14.03% and 13.20% from 2009 - 2018.
*YTD July 26, 2019
Data as of July 29, 2019. Returns are in USD

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The average annual return over the last 39 years is 9.61%. However, in order to obtain this return, investors had to endure an average annual drawdown of 14.03%. In some years, the market fell by as much as 20% at certain times, only to finish with a similar positive return. You can't have sunshine without the rain. Richards realized long ago that his job was not to find great investments, but to help create great investors. He observes that simply making good investments and behaving correctly enables investors to outperform 99% of their peers.

What a difference a day makes....

Now, investors might think that moving in or out of the market for a few days here and there will make little difference to their profits. But someone who missed just the best 25 trading days on the S&P 500 since 1988 would have lost out on almost half of the market's 10.2% average annual return over that period.

Making decisions based on short term volatility is a recipe for disaster. If you were to look at the monthly performance of the S&P 500 over any reasonable period, the peaks and troughs appear alarming. But if you look at the returns over a longer time frame, they are consistently positive.

There is an abundance of research demonstrating that investors' emotions and behaviour are a major determining factor in their long-term portfolio performance. Richards refers to the 'behaviour gap' - the difference between the higher investment returns investors can possibly earn and the lower returns they actually earn due to their emotional behaviour in responding to whatever is happening in the markets right now.

Beating the biases

The Corporate Finance Institute's list of the most common biases of behavioural finance include over-confidence; attributing good outcomes to skill and bad outcomes to luck; paying

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close attention to information that confirms the investor's belief and ignoring information that contradicts that belief; willingness to let a good story cloud the facts; reluctance to consider new information; herd mentality; and loss aversion.

Aversion to loss is a strong emotion that causes investors to make bad decisions. Kahneman and Tversky's prospect theory suggests that individuals are far more upset by losses than they are pleased by equivalent gains.

Happily, there are options for reducing the behaviour gap. Through proper diversification, the use of alternative investments, utilising a strategic reserve account (for retirees and pre-retirees) and having a trusted financial advisor, investors can reduce portfolio volatility without sacrificing returns.

We compared a 60/40 portfolios of equites and fixed income to a portfolio with 30% private debt divided equally between Canadian senior private debt and U.S. mid-market debt where S&P 500 and U.S. Bond index allocation were each reduced by 15%.

The portfolio with private debt outperformed the traditional 60/40 portfolio with lower volatility. In the months where stocks and bonds experienced negative returns and volatility, the private debt acted as a stabilizer. With lower volatility, there is less opportunity for investors to let their emotions negatively impact their investment returns.

A rational approach to investment reduces investor fear, making them less likely to buy at the top and sell at the bottom. What is most important?

Volatility will test your resolve and cause your emotions to soar. Enlist the services of a trusted financial advisor who will diversify your portfolio into private alternatives, lower your investment correlations and assist in sorting through the noise of the financial markets.

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Keep these key ideas in mind when markets and media are in a frenzy:

- Market volatility is normal; you can't have sunshine without the rain
- Bear markets will happen
- Diversify into private alternatives to lower volatility
- Focus on the long term
- Focus on what you can control

The legendary investor Warren Buffett says, "The most important quality for an investor is temperament, not intellect. You need a temperament that neither derives great pleasure from being with the crowd or against the crowd." In other words, keep your eye on the prize (long-term returns). The short-term noise is a dangerous distraction.

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