Resisting the Emotional Spin Cycle

SAPERS & WALLACK

As we look back over the first decade of the 21st century, we can draw one undeniable conclusion – it was a bear of a time for investors. Major market declines from 2000 to 2002 and then again in 2008 dragged equity returns well below their long-term averages.

But research will show that, as disappointing as the markets have been, the average investor has fared far worse. As defined by Dalbar, Inc.,[1] the average investor refers to the universe of all mutual fund investors whose actions and financial results are restated to represent a single investor. This approach allows the entire universe of mutual fund investors to be used as the statistical sample, helping to ensure ultimate reliability.

Caught in the emotional cycle of investing, many investors continue to pull in and out of the market, abandoning longterm strategies, and paying the price with suboptimal returns.

A study of investment behavior by a major investment research firm underscores the point. Dalbar, Inc., compares the longterm returns (up to 20 years) of equity fund investors against the S&P 500 Index, which represents a buy-and-hold strategy. In every year since 1992, the average investor has significantly underperformed the index. And although the gap between the two has narrowed in recent years, the average investor continues to hurt themselves with their investment behavior.[2]

As we tell investors time and again, focus less on market behavior and more on your own behavior. The research shows, market timing doesn't pay.

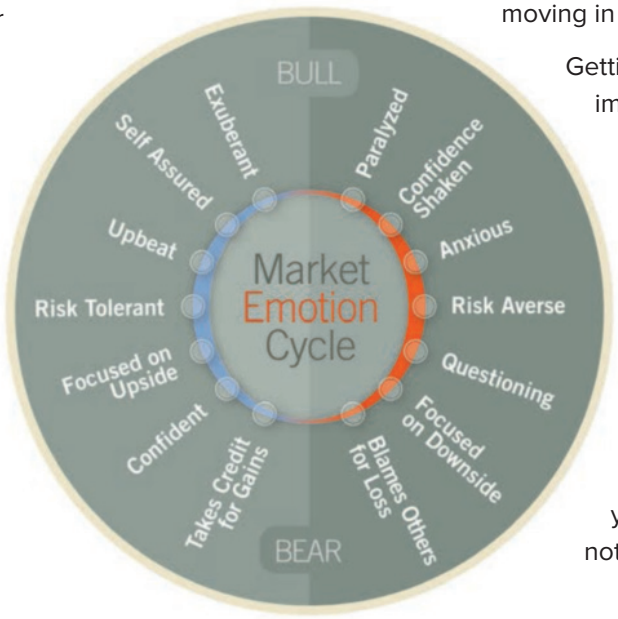
Below are several strategies that have served investors well for generations. Diversification. Dollar cost averaging. Patient and consistent investing. These things matter. When others in our industry began to question these time-tested practices, we did not. Nothing that has happened throughout this recent market cycle has eroded our faith in the value of remaining fully invested – in all markets – and focusing steadfastly on long-term goals.

Don't fall into the trap of buying high and selling low

Do you remember the heady years from 1995-1999 when it seemed the market could only go up? Fueled by the dot.com boom, investors flocked to speculative investment options in record numbers. Upbeat and confident in their supposed investment acumen, they focused on the upside, ignoring risks and inflated prices. When the bubble burst in 2000, it wiped out significant wealth and investors learned a hard lesson.

In the 2008 bear market, we saw the opposite happen, as skittish investors sold their investments or moved to cash in equally disturbing numbers. Confidence shaken by steep declines, investors grew anxious, many abandoning well-thought-out strategies. Even though stock prices were at record lows, investors focused on the downside and looked for someone to blame. And while investor sentiment has improved measurably, many continue to let fear be their guide.

From 2000 through 2002, the S&P 500 declined each year. During that same timeframe, investors experienced a Guess Right Ratio at or below 50%. This ration, published by the investment research firm, Dalbar, Inc.,[3] measures how often the average equity investor makes a good timing decision. This same trend emerged again in 2008, when the market experienced a significant decline and investors' attempts to time the market were largely unsuccessful (42%). As the markets improved, investors began to make the right decisions more often in 2010 and 2011. However, in 2012 investors' Guess Right Ratio was the second lowest since 1993. While the market was rising, investors were leaving money on the table by moving in and out of funds at the wrong time.



Getting the picture? Timing is difficult and impatience may erode return. Picking a strategy for each of your goals and sticking with it – assuming your individual circumstances haven't changed – is often the most viable solution. But as we've shown, many investors find it difficult. So what should you do now, particularly if you have been sitting on the sidelines with money to invest? Here are some positive steps you can take, remembering that doing nothing is likely not a good option.

Where Are You Right Now on the Market Emotion Cycle?

Manage your behavior

When it comes to behavior, too much knowledge is a good thing. When markets move through their cycles, investors should avoid getting caught in the emotional highs and lows. The best course for most long-term investors is to change their strategy only when their personal circumstances change, not when the market changes.

Re-evaluate goals

Staying focused on your goals can serve you well in various markets. To ensure your strategy is appropriate, now is the time to revaluate goals and re-assess risk tolerance and time horizon. After two bear markets in 10 years, many investors have decided that they're not as risk adverse as they originally thought. Further, there's evidence to show investors focused on goals – as opposed to returns – are more likely to stick with a strategy.

Take advantage of dollar cost averaging

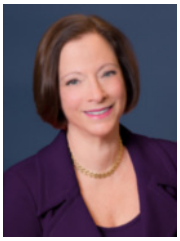
A simple way to systematically ease back into the market is dollar cost averaging – a good option to help avoid buying high and selling low.[4] Simply put, it involves contributing the same dollar amount to an investment irrespective of price. Let's say you're contributing $500 per month to a mutual fund in your IRA, which is priced at $10 per share. With each contribution, you're purchasing 50 shares. If the price drops to $9, your contribution will buy 55.5 shares. If it goes to $11, you'll buy only 45.45 shares. You're buying more shares when the price drops and fewer when it rises. Over time, consistent contributions – as opposed to stopping and starting – will help lower your overall investment costs.

Face the facts. Look inward.

As you evaluate your situation, keep two things in mind. First, volatility is a fact of life. The majority of successful investors ride out the dips in the road no matter how steep. Second, history has shown that a diversified investment portfolio of fixed income and equity investments can help increase the likelihood you'll outperform inflation, an investor's biggest nemesis.

Finally, rather than looking outward – at the market – look inward. What are your goals, what levels of risk can you really live with during difficult periods, and what steps can you take now to ensure you are prepared for whatever the future holds?

Our goal is to help you stay on track in pursuing your goals.



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[1] Dalbar, Inc., Qualitative Analysis of Investment Behavior, 2013.

[2] Dalbar, Inc.

[3] Dalbar, Inc.

[4] As with any investment strategy, there is no guarantee DCA will be successful. Before choosing a DCA strategy investors should consider their ability to stay invested throughout different market environments.