Reset

February has been a very interesting month this year. For the first time in a while stock prices decided to show some vulnerability and the downside, as often happens, was quick and dramatic. While we've seen some pretty big up days for the Dow Jones Industrial Average over the last year, the two down days of over one thousand points were bigger by comparison, especially given their proximity to one another this month. I may be alone in this, but this pause in the relentless upward movement in stock prices seems very healthy for investors.

Recency Bias

While markets over long periods of time reflect the collective wisdom of all investors, shorter periods sometimes show collective thoughts might be less wise. The build up to the housing bubble from 2003 to 2008, might be a reasonable example. Behavioral Economics is the study of how real live, flesh and bone human beings are impacted by perspectives and emotions, as they make financial decisions. One very powerful thing that works on all of us is that we tend to project what has happened recently to continue indefinitely into the future. Our bias is that if stocks have gone up over the last year, they will of course go up as much next year. In 2009 it was the opposite. Many people felt that no one would ever make money in stocks again. Our Recency Bias works this way, even though logically we might admit that things are constantly changing.

Status Quo Bias

Speaking of change, while we might know change is occurring, our strong preference is that things would stay the same. Maybe this desire comes from wanting to know what we can expect or we just value reliability. Reinforcing the Recency Bias, is this desire for things to pretty much stay the same. We have a bias in favor of the status quo, especially if we like what is happening now. Also, never underestimate an underlying fear that things might get worse and we never want that.

Trend-Chasing Bias

Alright, I won't go through all of the dozens of biases the Behavior Finance scholars have researched and uncovered over the years. Face it, we all like big positive numbers when it comes to investment returns. We naturally like seeing bigger numbers in our banking, savings and investment accounts. We are prone to look at what has done well and want to put a saddle on that horse. Anecdotally, back in the 1990s, our predecessor firm took a comment from the CEO of a mutual fund company and back tested an idea. This CEO each January would move money in his firm's 401(k) plan to the worst performing funds of the year before.

Our firm back tested his idea and found that his process performed better than staying in the best performing funds of each year. Now please understand that this is not a suggestion that the reader do this. Your selection process should include a host of other criteria. I mention it here just to suggest that chasing the hottest funds of the prior year, trend-chasing, is natural emotionally. It may, however, not give you the best result, especially adjusting for the risk you might have to take. Trend-chasing bias, while natural, may not yield the results you desire.

Take A Stand

Okay, so we are completely human and all subject to natural biases. So how do we proceed in a world of ups and downs and more specifically, in a world where prices can get out of whack for a while? Last month a very bright person from one of the world's great investment houses shared the best advice he ever heard. It was to invest more, more often and to pick a comfortable risk level and stay with it. Pick a percentage to have in bank deposits, stocks, bonds, real estate, alternatives and perhaps commodities and stick with your percentages for the long haul……..and add to it as frequently and liberally as you can.

Bottom Line

Talking with investors in 2009 they wanted to focus on risk. In 2018 they want to talk about 2017 returns. Our behavioral biases are fascinating, as they often cause us to focus on the opposite factors than those we should be considering. As I wrote last month, the majority of the economic factors point to continued slow global growth, which should be good for investment markets in general this year. The take away here is to figure out an investment stance that you will be comfortable maintaining through the ups and downs, because we are all human and we are all entitled to our biases……….especially where the emotional subject of our financial wellbeing is concerned. Please let me know how I might help.

Your Feedback

I would love feedback on this newsletter. Future issues may include a host of good ideas, insights, specific steps to take financially, life insights and of course "Wit and Wisdom". Most importantly, I'd like it to be of value to you and to encourage an exchange of great ideas and insights. Please send your feedback to:

Colin S. Mackenzie, CFP®, AIF®
Cetera Advisor Networks LLC, Member FINRA/SIPC
301 E. Colorado Blvd, #400
Pasadena, CA 91101
mackenziec@ceteranetworks.com