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Portfolio Perspectives

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Mental Landmines

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When you look at the annual returns for the S&P 500 index for the past five years as displayed in the table below, what do you think are the odds of the S&P 500 earning a positive return in 2014?

S&P 500 Annual Returns

Year	2009	2010	2011	2012	2013
Return	26.5%	15.1%	2.1%	16.0%	32.4%

Source: Morningstar Direct, January 2014. Past performance does not guarantee future results. Indexes are unmanaged baskets of securities in which investors cannot directly invest; they do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio.

Many would predict that the odds are against a positive return in 2014, simply because they think the bull market has lasted too long. Unfortunately, some investors will adjust their portfolios or move out of the market altogether because of this thinking. But when you understand the gambler's fallacy, you might think twice.

The gambler's fallacy is the tendency to over-predict reversals in situations such as coin flips, games of chance and market returns. Hersh Shefrin, Professor of behavioral finance at Santa Clara University, explains the gambler's fallacy using a coin flipping example in a 2007 paper.[1] In his explanation, Professor Shefrin points out that many people incorrectly presume the probability of a tail on a sixth coin flip — after five heads in a row — to be greater than the actual probability. This is because they know that roughly half the flips in any long stretch should be tails and they have not seen a tail for a while.

Going back to our initial question about the performance of the S&P 500 in 2014 — did you know that the S&P 500 actually has a 3 to 1 shot at being positive, irrespective of previous year returns?[2] A 3 to 1 shot is really good and most investors would agree if they were able to see through the illusion of the gambler's fallacy.

Another illusion that plagues sports followers and investors alike is the hot-hand fallacy. In sports, the hot-hand fallacy leads to predicting that a player will continue to be hot because his recent performance has been hot, while for investors it is the fallacy that a hot manager or asset class will continue to perform well given recent performance. More generally, the hot-hand fallacy involves predictions of unwarranted continuation when observing processes that are unknown. The belief that streaks have predictive power is an illusion that can cause investors to make poor decisions.

The chart on the next page shows the 2013 returns for several asset classes. The developed stock markets experienced double digit returns for 2013 but bonds, US REITs and Emerging Markets ranked at the bottom in returns. Are you going to buy only hot asset classes and avoid cold ones the next time you add money to your account? Or will you remember that just because an asset class performs at the top of the list one year doesn't mean it won't be at the bottom of the list the next year?

2013 Asset Class Returns									
Asset Class	US Large Cap Stocks	US Value Stocks	US Small Cap Stocks	US REIT Stocks	Int'l Value Stocks	Int'l Small Stocks	Emerging Markets Stocks	Global 1-5 Year Bonds	US Gob/ Credit 1-3 Year Bonds
Return	32.4%	32.5%	38.8%	1.2%	21.5%	25.6%	-2.6%	0.6%	0/7%

Source: Morningstar Direct, January 2014. Market segment (Index representation) as follows: US Large Cap Stocks (S&P 500 Index), US Value Stocks (Russell 1000 Value Index), US Small Company Stocks (Russell 2000 Index), US REIT Stocks (Dow Jones U.S. Select REIT Index), International Value Stocks (MSCI World Ex USA Value Index (net div.)), International Small Stocks (MSCI World Ex USA Small (net div.)), Emerging Markets Stocks (MSCI Emerging Markets Index (net div)), Global1-5 Year Bonds (Citi WGBI 1-5 Yr Hdg USD), US Gov/Credit 1-3 Year Bonds (BofA ML Corp & Govt 1- 3 Yr TR).

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The gambler's and hot-hand fallacies plague gamblers, sports fans and investors alike. The five-year bull market has many investors on edge, wondering if next year will be the year of the bear. But if you can recognize and understand these illusions you'll have a better chance of making wise investment decisions.

[1]Shefrin, Hersh, Behavioral Finance: Biases, Mean-Variance Returns, and Risk Premiums, CFA Institute Conference Proceedings Quarterly, June 2007.

[2]Since 1926 the S&P has been positive 64 out of 88 years or roughly 75% of the time, which equates to 3 to 1 odds.

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