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LORING WARD

Portfolio Perspectives

Monthly Insights for Investors

Could You Be Your Own Worst Enemy?

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"The investor's chief problem — and even his worst enemy — is likely to be himself."

— Benjamin Graham
The Intelligent Investor, 1949

The U.S. stock market (measured by the S&P 500) was down more than 5% two days following the historic Brexit vote. Investors sold out of stocks as it seemed the market was on course for a global market correction. Yet, only five trading days later the market was near its pre-Brexit level. I believe the panic was unwarranted and investors succumbed to their emotions yet again.

Why do so many investors make investment decisions based upon emotional reactions to short-term events? One possible answer: Because we're human. It's normal to feel anxiety during economic downturns or market turmoil — like Brexit — but acting upon those anxieties can lead to imprudent investment decisions. The key is not letting your emotions get in the way of your long-term investment plans.

One way to keep your emotions from demolishing your well-laid investment plans is to recognize that you are human and, as such, have flaws. Behavioral finance helps us understand these flaws. The Nobel Prize in Economics in 2002 was awarded to Daniel Kahneman for his work in this field. His research deals with cognitive errors and behavioral biases that all of us tend to have, especially in times of stress. Here are a couple of examples, specifically noting how they apply to investing:

Confirmation Bias refers to the tendency of people to look for information that attempts to support their beliefs. Meir Statman, Glenn Klimek Professor of Finance at Santa Clara University and member of the Loring Ward Investment Committee, said this about confirmation bias: "Investors who believe that they can pick winning stocks are regularly oblivious to their losing record, recording wins as evidence confirming their stock-picking skills but neglecting to record losses as disconfirming evidence."

Hindsight Bias is the belief that a past event was more predictable than when the event took place, or, "I knew it all along." Sports fans know this as "Monday Morning Quarterbacking," as it is always easy on Monday to see exactly what decisions the football coach should have made in Sunday's game. From an investing standpoint, this bias can lead investors to be overly confident that they possess superior investing abilities.

Many investors today are fatigued by the gloomy news and market volatility, and as a result they succumb to these thinking errors and biases that prevent them from sticking to a well-thought-out investment plan.

It is important to recognize that any investment, no matter how conservative, may be subject to risks. Some investors may find themselves substituting one form of risk for another:

- Stuffing cash in your mattress may seem prudent, but you're out of luck if your house burns to the ground
- Bank savings accounts provide a measure of stability, but generally are unable to keep pace with inflation, meaning that you may need to decrease your spending so your money can last throughout your retirement
- Some pundits tout gold as a safe commodity, but gold and all other precious metals have experienced price fluctuations throughout history

When the markets are unsteady, investing requires discipline and patience in order to overcome emotional tendencies. It's certainly easy to give in to the temptation to make major changes to your asset allocation every time the market slumps or soars. Likewise, it's tough to stand firm when the herd is stampeding this way and that, chasing after the latest hot fad. The more we can learn about how our emotions can get in the way of making wise financial decisions, the more likely we are to be able to balance those emotions with reason.

Our continued message of "stay the course" and "tune out the noise" may feel boring or outdated, but may be an appropriate choice for long-term investors with a prudent, diversified investment portfolio.

An Asset Class Investing philosophy isn't flashy, and it's not always popular in some quarters, but it has helped many investors over the long haul. We strongly believe it will remain an appropriate choice well into the future.