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Great Expectations: How Investors Mistake Past Conditions for a Leading Indicator

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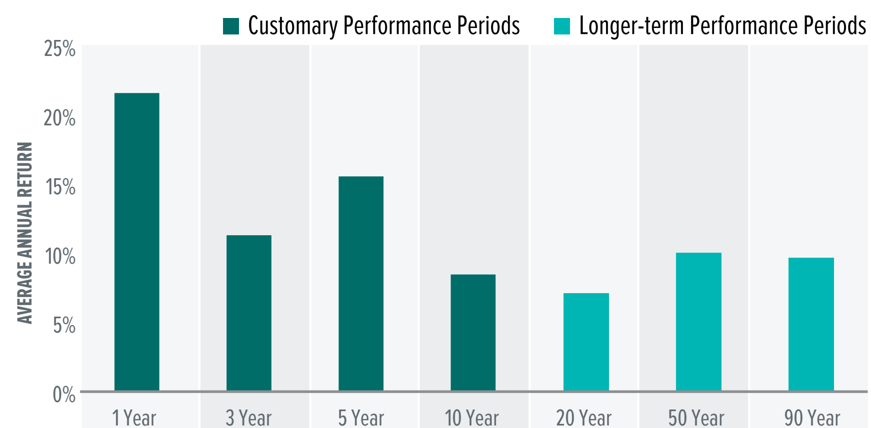
Snapshot

- The recent past can have a profound influence on our perception of the future.
- As investors, this can cause unrealistic performance expectations—especially if the market is many years into an upward trend.
- We believe that looking further into the past can provide a more realistic and useful perspective of the future.

Since 2009, investors have grown accustomed to the rising asset prices generated by the current bull market in U.S. stocks (and, to varying extents, in other equity markets around the globe). The youngest of investors have likely never experienced a sustained selloff larger than a 10% decline (commonly referred to as a "correction"). And as for older investors, their memories of loss experienced during volatile times that preceded the current bull market (like the global financial crisis or tech bust) have likely been dulled by the passage of time and the recovery of losses. The lack of such memories—whether altogether absent or clouded by recent events—can result in investors shaping unrealistic future performance expectations.

Professional investment managers often seek to mitigate this by depicting customary performance that includes average returns over 1-, 3-, 5- and 10-year periods. But there can be limitations to this measure. When applied to a generally persistent uptrend like the one experienced by the S&P 500 Index since 2009, providing customary performance would likely encourage (rather than temper) high hopes for the future (Exhibit 1). Comparison against significantly longer timeframes reveals that U.S. stocks generally benefitted from an investment environment over the last several years that, on average, has been considerably more hospitable than the long-term experience.

Exhibit 1: Customary Performance Can Encourage Unrealistically High Hopes



Total return for the S&P 500 Index (and S&P 90 Index, its predecessor, until 1957)
Source: Aswath Damodaran "Annual Returns on Stock, T.Bonds and T.Bills: 1928 – Current;" New York University Stern School of Business

Getting the Wrong Idea

Academic research supports the sentiment that investors largely ignore the long-term picture. In analyzing data from 1963 to 2011 that represents investor expectations of future equity market returns, Harvard Business School economists Robin Greenwood and Andrei Shleifer found that investors have a positive market outlook when stock prices are elevated and have been rising.[1] The study also discovered that investor "expectations are also highly correlated with investor inflows into mutual funds"—suggesting that investors not only feel optimistic based on a recent positive trend, but also make investment decisions consistent with those feelings.

The behavioral pitfall underlying this tendency is known in the academic world as **recency bias**. It's grounded in our ability to recall recently acquired information more easily than information obtained further in the past. Recency bias is a close cousin of **availability bias**, which is defined as the impulse to consider items or events "by the ease with which instances or occurrences can be brought to mind."[2]

Accounting for Poor Behavior

Behavioral biases like recency and availability stem from a type of cognitive processing rooted in intuition. This type of "thinking", termed **System 1** by behavioral economist Daniel Kahneman, really speaks to how the brain processes feelings—prioritizing automatic, quick, effortless shortcuts. This is in contrast to **System 2**, the second type of cognitive processing, which Kahneman says is "active in deliberate memory search, complex computations, comparisons, planning, and choice."[3]

We believe that System 2 is the antidote to investors' behavioral biases, as it allows us to consciously expand our frame of reference. In our view, feelings about the future should have no bearing on how to make investment decisions. Investors who consciously study performance statistics over a long time horizon—including average performance over many decades as well as single- and multi-year periods—will likely gain a more thorough understanding of what markets are capable of producing on average and at upper and lower extremes.

Better yet, investors could benefit from exploring the long-term relationship between asset prices and fundamental measures like earnings, sales, dividends and others. Comparing the long-term levels of these valuation measures against their current levels can provide a much more reliable basis for expectations than that which is recalled from the recent past.

[1] "Expectations of Returns and Expected Returns;" Greenwood, R. and Shleifer, A. (2013). Harvard Business School
[2] "Judgment Under Uncertainty: Heuristics and Biases;" Kahneman, D. and Tversky, A. (1974). Science
[3] "Thinking, Fast and Slow;" Kahneman, D. (2011) Farrar, Straus and Giroux

Index Definitions

S&P 500 Index: The S&P 500 Index is an unmanaged, market-capitalization-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

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