Nexus Notes

December 17, 2012

Friends,

I recently came across a couple of terms: "Recency Bias" and an alternate definition for OCD, "Obsessive Crisis Disorder". The first is defined as the tendency to extrapolate recent events into the future indefinitely. The second is the tendency to view minor negative occurrences as the beginnings of major crises. It seems that the former has a direct bearing on the latter. To rectify tendencies like these, the comedian Bob Newhart (playing a psychologist in a Mad TV comedy skit) would shout, "Stop it!" If it were only that easy.

Ostrich: I can certainly understand why there has been an outbreak of these subconscious psychological tendencies and why, in the face of the 2010 "Flash Crash", the 2008 market meltdown, and the 2002 dot com crash, one may want to bury his or her head in the sand, i.e., move all investments to cash. Unfortunately, as one may be running from the uncertainty of future investment performance, they may be running to the certainty of purchasing power loss over the long term. The difference between interest rates and inflation rates is called the real rate of interest. We are in the middle of experiencing negative real rates of returns because inflation rates have been higher than current cash interest rates for a while and are expected to remain there for at least the next couple of years.

Strategy: This is the point where advisors will begin quoting various facts, figures, historical parallels or other rational arguments to try to overcome Recency Bias and Obsessive Crisis Disorder. In other words, their version of "Stop it!" One of the major determinates for portfolio construction is the time horizon that has been assigned to a given portfolio. As the portfolio begins to approach the originally set time horizon, steps must be taken to reduce volatility and risk by moving into bonds or cash equivalents. This is not to say that these moves will prevent a possible negative return in any one year, however, they may greatly diminish the negative impact of a bad market year on the performance of the portfolio over its entire holding period. Regularly scheduled reviews help reassess the portfolio in light of any changes to your personal time frames and objectives.

Recency Bias and Obsessive Crisis Disorder can be overcome. There is no secret to it. Look at where you are now. Look at where you want to be. Follow the roadmap and be ready to take the detours. Remember, a detour is just another way to get to your destination. Be sure to enjoy the view.

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