FACTORS IN FOCUS

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Perspective, Recency & Patience

by Eric D. Nelson, CFA

After an up and down (or, more accurately, a down and then up) start to 2016, we're now sitting on two years of negligible results for our portfolios and about three years with returns below historical averages. For even the most well-heeled client, this is frustrating. For others, you have to be wondering if there's a better approach.

Why Do We Invest?

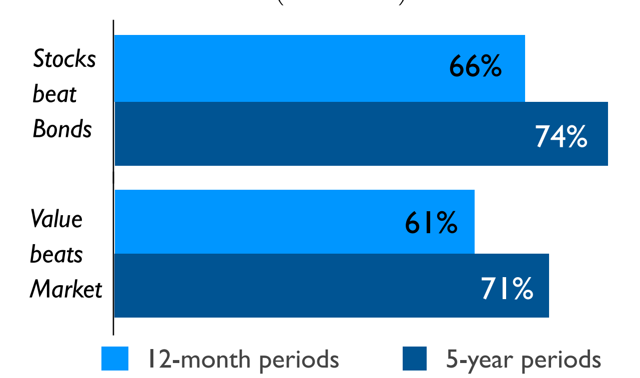
Stocks are an essential part of our investment plans because of the opportunity they offer to earn high returns that will help fund our long-term financial goals. As minority owners in several thousand businesses, we share in the profits (through appreciation and dividends), but we also must pay the price when these same companies lose money and even go out of business. Another way to think about this is to ask the question—if stocks weren't risky, or riskier than the alternative (say bonds or CDs), why should I expect a high return? Usually, but not always, we're rewarded for owning stocks.

The same relationship also holds between safer stocks, those that typically populate the S&P 500, and riskier small/value companies. Who would want to own shares of these stocks, that are relatively less profitable or are in industries with below-average growth, if you didn't expect a higher long-term return for owning them? Indeed, as Chart 1 shows, value stocks have outperformed the market (which is dominated by large cap, growth-oriented stocks) with about the same frequency that stocks have outperformed bonds.

Recency Bias

Our recent experience has been one where stocks (including international companies) have underperformed bonds and small/value stocks have underperformed the market. Chart 1 shows us this result is simply one of those rare but inevitable periods of disappointment we have to endure to achieve our desired returns.

Chart 1: Periodic Results (1928-2015)



"Stocks/Market" = DFA US Market Index, "Bonds" = Five-Year T-Notes, "Value" = 60% DFA US Large Value Index, 40% DFA US Small Value Index

Most people don't respond rationally to periods like these that deviate from their long-term expectations. We tend to put a lot more emphasis on what has happened most recently to our portfolios, and we assume that the near-term trend will continue for the foreseeable future.

This tendency is so prevalent that psychologists actually have a name for it: recency bias. And because we all have a blind spot when it comes to recognizing our own shortcomings or flawed thinking, it's next to impossible to recognize that you're making this mistake (we have an easier time spotting these biased behaviors *in others*, which is what makes a financial advisor with a knowledge of behavioral psychology so helpful in preventing us from making bad decisions).

Recency bias becomes extremely costly when it causes us to act in ways we shouldn't—deviating from our long-term plans or abandoning them altogether. It causes some to postpone future contributions into their portfolios until the situation appears to be "improving." Others avoid implementing a plan that has a high probability of achieving their long-term goals for fear that the early results will be disappointing. Still others sell some or all of their existing holdings so they can buy other investments that have recently performed better (ignoring their long-term characteristics or inherent risks).

Table 1: Investor vs. Investment Returns (1991-6/2013)

	Actual Returns	Return Investors Earned	Difference
Retail Funds	+8.9%	+7.1%	-1.8%
Institutional Funds	+8.8%	+6.8%	-2.0%

source: Journal of Portfolio Management, Winter 2016, "Timing Poorly" Hsu, Myers and Whitby

Table 1 quantifies this risk by looking at mutual fund returns compared to the returns mutual fund *investors* actually earned net of their buying and selling decisions. Whether we look at retail funds —those with lower minimums and higher costs, or institutional funds—typically the lowest-cost funds with higher minimums of $100k to $1M or more (the ones you own), investors lost between 1.8% and 2% per year in returns based on poor decision making. How much of this was due to recency bias? In my experience, a lot of it.

Patience Is Profitable

The hardest part about achieving a successful investment experience and accomplishing your long-term goals, is living with and sticking to the decisions you've made. We're not wired to wait, to look past periods of time where our results differ from what we had hoped or expected. Quite simply, what works in investing—the fundamentals and principles that your plan is based on—doesn't always work.

That's why patience is such an important component of financial success. Even the best decisions don't always go as planned and we naturally react by wanting to make a change. It always feels better to be doing something. Doing anything. Except we don't invest to *feel* well. We invest to *do* well. For ourselves, for our families and for our loved ones. So be patient. If not for you, then for them.

Edited by Kathy Walker