Healthy Investing Behavior

Markets have been continuing a steady expansion for some time now, but they were not always this great nor were they always smooth. During the 2008 financial crisis for instance, many investors fell on hard times, questioned their strategies, and abandoned ship. Eventually, however, the markets rebounded and those who stuck with their long-term plan recovered all loses and gained far more. We believe those who adhere to their long-term goals will continue to be rewarded.

We often direct our client's focus to factors that may affect their investing discipline. The media, international events like Brexit, and even domestic occurrences such as the 2016 elections can push investors to make rash decisions that contradict their long-term investment goals. Recent studies regarding investor reactions to media and events suggests that coaching clients toward good investing behavior is perhaps the greatest value advisors add.

Eat Your Vegetables

Examples of good investing behavior include: saving enough for retirement or college, investing it at the appropriate risk level, and avoiding market timing and stock picking along the way.

Just as health care officials realize that communicating exercise and nutrition information can have as significant of an impact on individuals' health as the development of new medicines, so too are advisors today focusing on coaching investment behavior in addition to the economics and managing money.

As of March of 2016, nearly one in three Americans had not saved anything for retirement.[1] The government recognizes this as such a huge problem that it is now considering default or forced enrollment in corporate retirement plans, even in the private sector. But simply budgeting better and prioritizing one's future could solve this for most. Not all of us want to eat our vegetables, but they contribute to our healthy future.

Researchers are looking for creative solutions. One involves showing people digitally-enhanced photos of themselves, made to appear in their 70's. Viewing a shockingly real image of oneself in retirement makes people more likely to save. In another study, researchers found that those who have set a specific retirement date are more likely to save appropriately.[2]

Don't Play with Your Food

From 1995 – 2014 the S&P 500 Index returned 9.8% per year (near the 200-year historical average of stocks), however, the average investor in equity mutual funds earned only 4.8% per year.[3] This difference is primarily attributable to investors hurting themselves by becoming overly cautious at market bottoms and overly aggressive at market tops.[3]

We cannot overemphasize the need for investors to self-reflect and recall their past feelings during market extremes. This reflection may help investors stick to their long-term strategies in the face of negative media and resist selling during challenging times.

Meir Statman, Professor of Finance and Behavioral Finance at Santa Clara University, is developing cutting-edge research in behavioral finance and coaches Registered Investment Advisors (RIAs) like ourselves. Statman believes the biggest contribution from RIA to client is investment-behavior coaching.[5] "Clients are their own worst enemies," says Statman. "Advisors cannot beat the market. But they can prevent clients from doing really stupid things." The same biases in our brains that help us in other aspects of life (e.g. running from danger), hurt us when investing.

Statman, in his terrific book, *What Investors Really Want*, provides deep insight into the feelings and brain functioning behind investor decisions and offers the following advice:

Estimated Annual Portfolio Value Added by Advisors [4]

~ 0.5%	Tax Efficiency
~ 1%	Cost Savings
~ 1%	Asset Location *
~ 2%	Asset Allocation
~ 4%	Investor Behavior

Statman on Market Timing

"Individual investors tend to extrapolate from recent returns. If the market has been up, they think it will continue to do so; if it's down, they think it will continue to go down. But we know from systematic studies, including my own, that the relationship is just the opposite and that when investors are bullish, markets are more likely to go down."

This pattern of markets rising when investors feel panicky and falling when investors feel confident is so reliable that it is a key indicator watched by professionals. Several firms now publish measurements of investor bullishness/ bearishness. When the crowd is fearing that the latest stock market dip will lead to more declines and is wanting to sell, savvy long-term professionals are buying.

* "Asset Location" refers to the tax-reduction strategy of locating tax-efficient investments in taxable accounts and emphasizing tax-inefficient investments in tax-protected accounts like IRAs and 401(k)s. When all accounts are combined in the same portfolio strategy, say retirement or college, then wise asset location, can significantly reduce taxes, especially for those in higher tax brackets and living in high income-tax states like California and Oregon. Vanguard estimates this optimization is worth on average 1% per year, more for those in the highest tax brackets and/or with large IRA or 401(k) accounts.

Statman on Stock Picking

"When someone on television [recommends] to buy such-and-such stock, who do you think was also listening to the same program? Who is taking advantage of this before you have a chance to? Is it possible that some people knew ahead of time that the person was going to say that and positioned themselves to profit from it?"

"If you want to buy an investment because you're confident it's sure to go up, stop." The question to ask whenever you're buying is, 'Who is the idiot on the other side of the trade? Is it possibly Goldman Sachs?' Also: 'What do I know that isn't known that's going to give me an advantage relative to the person on the other side?' "

What about the analysts whom investors turn to for "buy" and "sell" recommendations? Picking stocks based on analyst ratings is of little help – not because their analysis is faulty, but because it is already seen by all. A Bloomberg study shows that in 2010 the S&P 500 firms with the most "buy" ratings gained 8.7%, while those with the fewest gained 20.0%. Another study by *InvestmentNews* showed similar results over the time period from the start of the recovery, March, 2009, through 2010. [6]

We are here to help investors balance their portfolios to the *appropriate* risk level, so they will not be tempted to change strategy at market extremes. Investors feeling the urge to sell at market lows likely should have been in safer portfolios from the beginning. We map portfolios to time-horizons supporting high-level goals such as, "retire at my current standard of living," "minimize estate tax," or "fund college tax-efficiently." We encourage clients to stick with these portfolios for their targeted time-frame, rebalancing periodically as assets grow at different speeds and changing strategy only to support life changes. Life events, not headline news, should drive portfolio changes. We are always available to listen, review data, and coach clients toward healthy investment behavior.

Notes and Acknowledgements:

1. "1 in 3 Americans Has No Retirement Savings," *Money*, March 14, 2016
2. *Fortune*, June 13, 2011
3. Dalbar's Quantitative Analysis of Investor Behavior 2015. Returns are for the period ending December 31, 2014. Average equity investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions and exchanges. Additional evidence is found in, "Putting a value on your value: Quantifying Vangard Advisor's Alpha," The Vanguard Group, Inc. & Morningstar, Inc.
4. "Giving Clients What They Need," Interview with Meir Statman, Professor of Finance and Behavioral Finance, Santa Clara University, AdvisorOne, May 20, 2011. Sharper Granite estimate based on various cost studies
5. Sharper Granite estimate based on several analyses including many from Vanguard
6. "When Analysts Say 'Sell,' It Is Time to Buy, Data Show," *InvestmentNews*, January 17, 2011

All forms of securities investing involve risk of loss for which clients should be prepared. There are no guarantees or insurances of principal preservation and market fluctuations of any level may occur and impact portfolio value. Past performance is not a good predictor of future performance. [Spring 2017]