Investing through the Toughest of Times – Expert Advice

"The best time to buy is when there's blood in the streets."

- Baron Rothschild

Rapid changes in our investments affect us in many ways. Sometimes, in almost the same moment we can feel both of the two classic investing emotions: *fear*, "what if my portfolio loses even more money", and *greed*, "with the markets so low, aren't there some easy-money opportunities right now?". We can be pulled both to invest more and invest less almost simultaneously, irrational as this is.

Different parts of our brain react given different situations. The limbic system, which is the oldest, most primitive, and very emotional part of the brain, drives us to react, often irrationally, toward fear or greed. Within the limbic system, the *anterior insula* is primarily concerned with avoiding risk, and for example, tells us to run from danger, while the *nucleus accumbens* (NAcc), motivates us to seek reward. The prefrontal cortex, the more sophisticated, "human" part of the brain which controls conscious, thoughtful and methodical behavior, tends to get pushed to the back seat when we are making financial decisions due to the predominance of fear or greed associated with financial decisions.

These behavioral finance insights help explain how, in the ten years from 1995 – 2014, the S&P 500 Index earned 9.8% per year, yet the average mutual fund *investor* earned only 4.8% per year.[1] Other studies over different time periods show similar results.

"The markets have averaged an annual rate of return of (about) 9.5% since 1926. But the average investors don't make anything like that, because they tend to get in at the top and out at the bottom."

- Burton Malkiel, Princeton University, former Dean of Yale School of Business [2]

Investors as a whole hurt their own returns through self-destructive behavior. In volatile times they ignore their goals and become panicky short-term traders. The result is a well-documented tendency to change strategy and to move in and out

of the market at just the wrong times, buying when markets are low and selling when markets are high. "*For investors as a whole*," notes Warren Buffett, "*returns decrease as motion increases*." [3]

"Perhaps the most important lesson I've learned is that no one – not even the most sophisticated investors analyzing the best data – can reliably predict how the market will perform over the next day, week, or year…

The most successful investors don't try to predict when the markets will rise or fall. Instead, they save and invest regularly, through both good and bad times, to take advantage of the tendency of stocks to rise over extended periods."

- Charles Schwab , founder of Charles Schwab & Company [4]

During troubled times it can be reassuring to review some of the strategies of the best in the investment business. What actions do we observe from the top *institutional investors* like Warren Buffett of Berkshire Hathaway and David Swensen, manager of the Yale Endowment; the leading *academic researchers*, like Merton Miller, Nobel Prize winner from the University of Chicago Business School, Burton Malkiel of Princeton, Robert Shiller of Yale, and Jeremy Siegel of the Wharton School of Business; *investment pioneers* like Charles Schwab, founder of Charles Schwab & Co., and John Boggle, founder of The Vanguard Group; and industry-leading *corporations* like Proctor & Gamble, Wells Fargo, Wal-Mart, Valero Energy and Walt Disney?

Through the market crash of late 2008, Warren Buffett continued investing methodically with the same strategy as always. He did not pick the market bottom perfectly, but his investments in Goldman Sachs, General Electric and Constellation Energy appear to be wise moves.

"No one can pick the bottom… invest when prices are far below intrinsic value and trust in the market's tendency to correct over time."

- Warren Buffett, Chief Executive Officer of Berkshire Hathaway [5]

David Swensen has led Yale's endowment to 12.6% per year average returns through the difficult period 1997 – 2016, including 8.1% per year during the difficult period from 2000 - 2009. [6] Yet he eschews stock picking and market timing, staying invested right on through the tough times. He agrees with John Boggle, founder of the largest mutual fund company in the world, Vanguard Group, that individual investors should focus on asset allocation and utilize index funds, ignoring individual stocks and market timing.[7]

"People get it completely backwards... They should be unhappy when prices are high because their contributions will buy less. When prices are down, they should be happy, because they're getting more bang for their buck"

- David Swensen, Chief Investment Officer of the $25 billion Yale Endowment [8]

The data may run counter to our limbic system reactions, but it is irrefutable, and it forms the backbone of these experts' success. These investing leaders repeatedly buy when times seem most dire. The chart below shows the massive gains of early market recoveries and explains why Warren Buffett wanted to enter the market in 2008 just as most were exiting. Unlike other investors, he sees the *opportunity* of a down market more than the threat.

Recoveries Are Front-Loaded [9]

Investment Strategy	Average Return 1 Year after Bear Market
Stayed 100% in stocks through bear market bottom	45%
Stayed in cash until 1 month after the bear market ended	32%
Stayed in cash until 3 months after the bear market ended	19%
Stayed in cash until 6 months after the bear market ended	12%

If avoiding stock picking and market timing temptations are so important, then what about those "experts" on the radio or television like Jim Cramer giving market timing advice and stock recommendations? First, remember that the media must be dynamic and entertaining to capture our attention. Most of the best answers in finance are old and boring: stick to a long-term strategy, diversify, keep costs low, etc. Daily stock picks and market buy/sell points are far more interesting. Second, much of media's target audience are day-traders and other heavy transactors, who, like gamblers, are drawn to the markets by the appeal of easy money, rather than by a long-term fundamental strategy.

> ***"Jim Cramer is a charlatan. He turns the serious issue of personal financial security into a joke. There is nothing that comes out of James Cramer's mouth that allows people to make intelligent investment decisions."***
>
> - David Swensen, Chief Investment Officer of the $25 billion Yale Endowment [8]

Academic researchers have studied the "experts" for years, tracking the universe of analysts, media pundits, mutual fund managers and hedge fund managers. The research in this area is deep, consistent and irrefutable. No one consistently picks stocks, bonds, interest rate direction, or market turning points consistently.

Still, along with stock-picking tips, market-timing advice and gimmicks are everywhere. Market charting tools that purport to determine future market direction are advertised daily on CNBC, and in the *Wall Street Journal* and other reputable business media. They are also offered as "trading tools" at many online brokers to help customers "trade like the pro's" and discover the market's future. They are all nonsense.

> ***"There's no free lunch. You can't just scan the newspapers, read research reports, and watch (TV), and hope to earn above-normal rates of return. To beat the market you'll have to invest serious bucks to dig up information no one else has yet. Because it looks easy, many people may be tempted to try it… but most 'active' investors are just wasting their time and money… The smart ones will stop trying… and become indexers."***
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> \- Merton Miller, Nobel Prize winner in economics, University of Chicago Business School [10]

Behavioral finance research shows that viewers or readers will tend to believe they have some special knowledge from information in the media. Market direction predictions, such as those from Jim Cramer and others in the media, help create investors' over-confidence according to behavioral finance experts like Princeton's Burton Malkiel, Yale's Robert Shiller *(Irrational Exuberance),* and Wharton's Jeremy Siegel.

> ***"Investors are often tempted to pursue a difficult course. They attempt to beat the market by timing market cycles… With the abundance of financial news, and commentary at our beck and call, it is extraordinarily difficult to stay aloof from market opinion. As a result one's impulse is to capitulate to fear when the market is plunging or to greed when stocks are soaring."***
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> \- Jeremy Siegel, Wharton School of Business [11]

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It is not just leading institutional investors and academic researchers who understand the concept of investing for the future when times are toughest. Top companies recognize this as well and, in tough times when profits are down, actually increase investment through research and development (R&D), expansion, and acquisition.

A McKinsey study shows high-performing companies are twice as likely as their industry peers to hike R&D spending during tough times.[12] In another study following the bear market of the 2000's, Boston Consulting Group (BCG) studied corporate deals in good times and bad. It found that the average corporate acquisition in downturns created an 8.3% increase in shareholder value after two years, while the average deal in good times resulted in a 6.2% drop in shareholder value.[13]

Leading firms were certainly in acquisition mode post – 2008. Oracle acquired Sun Microsystems, Fiat acquired much of Chrysler's assets at fire-sale prices, Toys 'R' Us bought FAO Schwarz to gain market share, and Valero acquired VeraSun, just when energy companies were most depressed. Wells Fargo stepped up to buy Wachovia bank during the October storm. In a CNBC interview, then-Wachovia CEO, Robert Steel, implied that given the turnaround in banking-sector health, Wachovia may have indeed survived without the sale. Wells now appears to be the winner in that deal.

The successful, fundamentally-sound institutional investors have learned to conquer the fearful instincts pulsing deep within the brain. They avoid tempting moves that hurt returns and profits, actually investing *more* when the economy is struggling. The academic research verifies the value of their behavior. Leading corporations practice this behavior at the corporate level through increased R&D, acquisitions, and expansions during tough economies.

Like Buffett and Swensen, the individual investor can show nerves of steel. For her, this means continuing with automatic investing programs and 401(k) contributions through downturns, and perhaps even looking to invest more aggressively when times are toughest. Above all, the individual investor should resist liquidating during downturns for purposes of market timing and should stay well diversified using proper asset allocation across index funds to guarantee participation in the upside. All the research shows that as challenging as this is, it is absolutely the optimal strategy.

"Trying to guess the market is a fool's game. Never underestimate the importance of asset allocation... then use index funds -- indexing wins."

- John Bogle, founder of The Vanguard Group [14]

Notes and Acknowledgements:

1. 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 Vanguard Advisor's Alpha," The Vanguard Group, Inc. & Morningstar, Inc.
2. Burton Malkiel, Princeton University professor, former Dean of Yale Business School and author of *A Random Walk down Wall Street*, as interviewed in "I know This Much Is True", *Barron's*, July 6, 2009
3. Warren Buffett, interview in "Cut Your Gains!", *Fortune,* March 20, 2006
4. Charles Schwab , founder of Charles Schwab & Company, *Oninvesting*, Spring 2009
5. Warren Buffett, Chief Executive Officer of Berkshire Hathaway, interview in *Wall Street Journal*, August 4, 2008
6. "Investment return of 3.4% brings Yale endowment value to $25.4 billion , *Yale News*, September 23, 2016
7. David Swensen, Chief Investment Officer of the Yale Endowment, interview in "The Money Game," *Fortune*, October 3, 2005
8. David Swensen, Chief Investment Officer of the Yale Endowment, interview in "Yale Man," *Worth*, January 2009
9. Charles Schwab Center for Financial Research
10. "An Interview with Merton Miller," Peter Tanous, *Investment Gurus*, February, 1997
11. *Stocks for the Long Run*, Jeremy Siegel, Ph.D., Professor of Finance, Wharton School of Business at Penn University. Professor Siegel is considered one of the world's leading experts in historical stock market data research
12. McKinsey and Company, June 22, 2009
13. Boston Consulting Group, June 22, 2009
14. John Bogle, founder of Vanguard Group, interview in "Six Lessons for Investors," *Wall Street Journal*, January 8, 2009

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]