THE PITFALLS OF SHORT-TERMISM

The market has turned more volatile, which makes it a particularly challenging time to stick to a long-term investment program. Yet, it is critical to have a commitment strategy in place in order to avoid the pitfalls of short-termism.

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An inventory of behavioural research built up since the late 1970s lends a great deal of support to Benjamin Graham's casual observation that investment decision-making is riddled with error. Our cognitive processes do not reflect those of an optimizing automaton taught by our economics textbooks, rather they embed a complex interaction between reasoning and emotion that – at least in the context of investing – can generate undesirable outcomes. A pertinent finding in the literature is the overwhelming presence of time-inconsistent and present-biased preferences, wherein we favour immediate rewards and avoid immediate costs often to the antipathy of our "long-run selves".

Reaping most of the benefits of an equity investment program requires patience. While average annualized equity returns through the past century have been roughly constant at +10% over holding periods from three months out to 10 years, annualized volatility is five to six times greater at the shorter time interval (**graph 1**). In fact, two-thirds of the time, a quarterly annualized return is likely to range between -12% and +36% despite the average experience. Importantly, work by Daniel Kahneman, Amos Tversky and other thought leaders in the behavioural field estimate that investors feel twice the pain from a dollar loss as the elation from a dollar gain. And, there's the rub: In order to harvest the full benefit of long-term returns, we have to find it deep within ourselves to sit through the discomfort of some shorter-term and possibly sharp losses.

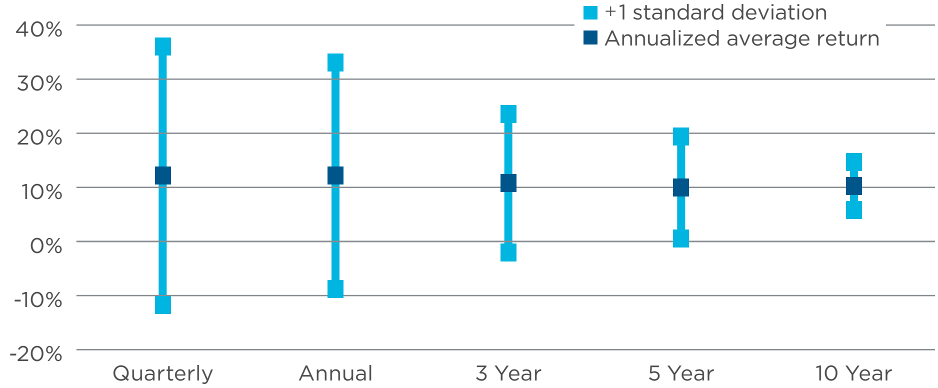
The data clearly argues that most investors find it difficult to stick with a long-term investment discipline. In fact, the hard-wiring embedded within many of us more often than not leads to immediate (re)actions that detract from our long-term goals. Depending on the methodology and time period, studies find that our ill-timed short-term buy and sell decisions in the equity market have diminished our portfolio's performance by anywhere from 1.2% to 4.3% per year (**graph 2**). While this might not sound substantial, a 30-year-old who initially invested $1,000, has left behind a meaningful $15,000 to $22,000 by retirement age.

The challenges we face do not stop here. While equity markets are generally quite volatile over short time horizons, we believe that the odds of large short-term price swings either up or down are much greater today given where we stand in the market cycle. We calculate that 74% of the top percentile of daily price swings (i.e., those moves in the order of ± 5%) since 1928 occur during periods when the S&P 500's 200-day moving average is declining; a development whose most recent start can be traced back to August 20, 2015.

"The investor's chief problem – and even his worst enemy – is likely to be himself."

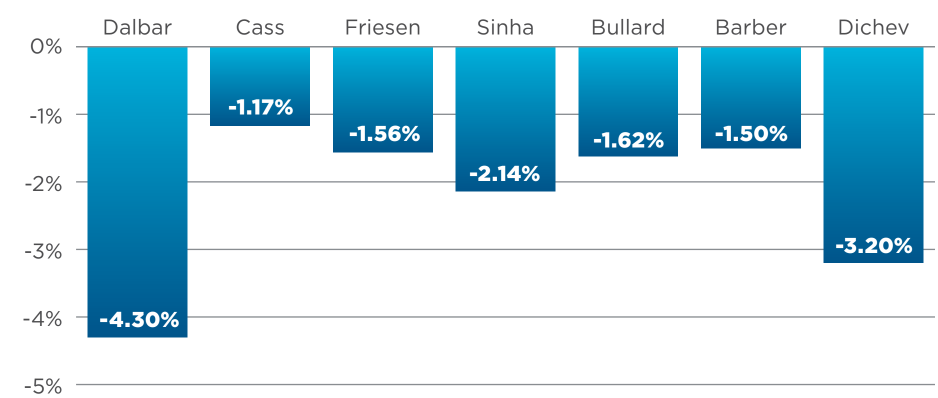
Benjamin Graham, 1949

1: Equity returns by holding period (since 1926)



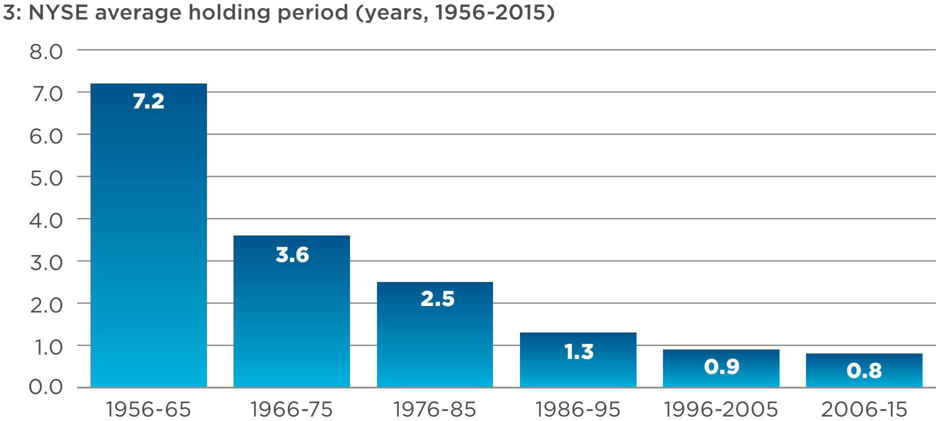
Source: Dynamic Funds, Prof. Kenneth French

2: Estimated annualized cost of short-termism (various studies)



Source: Dynamic Funds

3: NYSE average holding period (years, 1956-2015)



Source: Dynamic Funds

At the same time, we appear to be more short-term oriented than ever when it comes to investing. The average time we hold onto a stock is about 0.8 years versus 7.2 years back in the 1950-60s (**graph 3**). Technological innovation, the influence of around-the-clock financial news, and corporate communication and reporting practices might all be contributing to this increasingly myopic trend. Nonetheless, the greater draw towards noise trading is doing little to augment our terminal wealth.

While we could write an entire book on this topic alone, we believe there are several steps an investor can take in order to stick to a long-term investment program. A few of the basics are as follows:

1) Have a commitment strategy in place. What we mean by this is to establish a framework that will limit one's choices to those consistent with a long-term goal. An idea as simple as the involvement in a dollar-cost averaging program might do the trick.

2) Raise the cost of submitting to "temptation". An easy example is to provide oneself with objective reminders of the likely periodic and long-term risks and rewards of equity investing.

3) Most importantly, look at the market quotation screen as infrequently as possible. Work by Thaler, Tversky and Kahneman (1997) suggests that the less often an investor evaluates outcomes, the more likely he is to avoid noise trading and build a portfolio consistent with long-term risk-adjusted goals.

Investing is not easy, particularly in volatile times. However, having solid strategies in place that obligate one to align with longer-term goals will most likely build the pathway to a more rewarding investment outcome through time.

Keep up to date with Myles Zyblock s latest market views by reading his weekly Macro Musings and monthly Investment Junction reports on **advisor.dynamic.ca** or contact your Sales Representative for more details.