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Keeping Cool and Staying the Course — Mastering the Emotional Side of Investing

As we write, global equity markets are once again swooning in reaction to news flow from the ongoing credit crisis and the continuing writedowns financial institutions are taking on their holdings of mortgage-backed securities and structured securities comprised of them.

At times like these, investors are greatly unnerved by market action and wonder whether there is anything they can or should do in response.

Decades of market history have proven it is vitally important not to let short-term volatility alter your long-term investment plans. As the financial crisis has worn on, we have from time to time written articles giving the long-term perspective, in an effort to encourage our clients to stick with their investment program.

Bear Markets Are Common

Like it or not, bear markets are a fact of life for equity investors. According to JPMorgan Research, including this instance, there have been 31 bear markets since 1900 in the United States — or approximately one every three years. The rule of thumb we learned long ago is that, roughly speaking, the equity market runs on a four-year cycle. Of that, on balance roughly two and a half years are bullish, and one and a half years bearish. The 1980s and 1990s were glaring exceptions to this rule.

The 1980s and 1990s, when a large majority of investors cut their teeth in the stock market, were an unusual time in that bear markets were relatively infrequent and generally mild compared to the broader span of market history. We believe that in the future bear markets will occur on a more frequent basis, as was the case prior to the 1980s and 1990s. After all, the U.S. stock market is experiencing its second bear market this decade.

In our opinion, bear markets occur because investors collectively overestimate their time horizon and by extension their tolerance for risk. Equity markets exhibit higher volatility than markets for other asset classes for precisely this reason. And it is this volatility that investors in equities are compensated for in high long-term rates of return. In other words, high equity returns accrue to those investors who steel themselves against the regular occurrence of equity bear markets. It is those investors who panic and sell into lows that create the return opportunity for true long-term investors.

Pernicious Investment Psychology

In his recently published *"The Little Book of Common Sense Investing,"* author and investing legend John Bogle shares the results of a study of the actual return experience of mutual fund investors. The study demonstrates conclusively the cost of allowing emotions to take over in our investing activities. In his discussion, Bogle refers to the belief that investors' experience mirrors the return of the mutual funds in which they invest — he calls this 'The Grand Illusion.'

To determine the return earned by actual investors the dollar-weighted return of a fund must be calculated, which

takes into account the impact of investment flows into and out of a fund. The results of the study are sobering.

In reality, mutual fund investors as a group do not have the same returns as the funds in which they invest. Their returns are lower.

Over the 25-year period studied, U.S. mutual fund investors in the aggregate earned a compound annual rate of return of 7.3 percent. In contrast, mutual funds on average earned 10 per cent annualized over the same period.

What explains the difference between the returns?

Mutual funds investors would consistently sell their funds when they were down, and buy them when they were up. In other words, mutual funds investors were chasing performance.

Chasing performance is the exact opposite of the market axiom 'Buy Low, Sell High.'

We can extrapolate from this study an inference that investors generally miss out on the returns of the overall market, for exactly the same reasons – panicking and selling in a falling market, and chasing the ensuing bull market.

Over an extended period of time, the costs of chasing performance are enormous. In effect, the return of the overall market will only be experienced by those who are **continually** invested. The high returns experienced by the long-term investor accrue from those who forgo those returns by abandoning their equity investments when markets are down.

As we have written before, in our view the main element of the practice of investing is nothing more than an attempt to minimize remorse. Human nature being what it is, we punish ourselves for owning too much of an asset that has disappointing performance, and we punish ourselves for owning too little (or none at all) of an asset that has been performing extremely well.

Unfortunately, it is impossible to minimize remorse in advance; no-one can know the future with certainty. So, in constructing an investment portfolio, we recommend a variety of asset classes in proportion to our return expectation and our tolerance for risk, and taking the investment horizon into account.

For investors with long-term investing horizons, we recommend a pronounced equity bias in portfolio construction, to take advantage of the long-term dominance of stock market returns over those of cash and bonds.

Times of high stock market volatility serve to remind us of the importance of diversifying portfolios, as diversification makes the periodic stock market setbacks more tolerable, and minimizes the risk that investors might reduce or eliminate equity exposure in times of crisis.

Looking back through market history, periods when the market is swooning and investors are panicking have been better times to hold one's nose and add equity exposure, rather than reduce it.

The Wisdom of Warren Buffett

As Warren Buffett has repeatedly said, he "tries to be greedy when others are fearful, and fearful when others are greedy." And, at trying times in the market, it would probably be most helpful for us to ask ourselves, 'What are the great investors like Warren Buffett probably doing in this environment?' If our answer is that they are probably buying, shouldn't we be doing that, too, or at least not selling to them?

Since 1998, government bond prices have been inversely correlated to stock prices, making bonds a fairly ideal portfolio diversifier. For example, as equity prices have been marked down in recent months, the government bond markets have rallied quite smartly, partially offsetting the mark-to-market losses on the equity side of portfolios.

The discipline of regular rebalancing to the strategic target asset allocation allows investors to take advantage of performance differentials amongst asset classes. So, at a time like the present, rebalancing in effect allows an investor to reduce the proportion of the portfolio in well-performing assets, in this case bonds, and to increase holdings of the poorer performing assets, stocks. Rebalancing then, allows investors to buy low and sell high.

Volatility is Returning

We need to keep in mind how unusual the bull market has been since October 2002 from the perspective of risk and return. From the lows in 2002, both the Canadian and U.S. equity markets rose in a fairly steady fashion, with most price pullbacks on the order of 5 to 10 per cent. When the stock market rises in such an orderly fashion, it becomes easy to forget that in the U.S. from 1900 – 2000 stocks lost money in 25 of the 101 years.

The reason for the pronounced equity bias in our recommended asset allocations is that over long periods of time, stock returns dominate the returns from cash or bonds. A look at the nearby chart of the S&P 500 price index helps us make our point. We believe that in most every year from 1900 through 2000, there were likely reasons that could be used to justify a bearish outlook on the market.

We recommend that investors concerned about this recent market volatility consult with their investment advisor to confirm that their strategic asset allocation is in line with their return objectives and tolerance for risk. In addition, with the recent downdraft in stock markets, and the rally in bond markets, rebalancing to the strategic target may be appropriate.

Chart 1: Standard & Poors 500 Price Index, 1928 - 2008 (Logarithmic Scale)

Source: Bloomberg

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