Handling a New Market Dynamic Post-Pandemic

Do We Invest With Our Hearts or Our Minds?

Collectively speaking, the stock markets can offer a remarkably reliable way to take a quick pulse of the state of commerce at any given moment in time. Some would say the ups and downs of the markets are not only governed by the hard dollars and cents, but also by the mind-set and psychology of the investors who participate in daily trading on the worldwide exchanges. Through our own investments, even if it is simply a routine retirement contribution in a 401k fund, we find ourselves playing a tiny part in the daily drama. Currently investors are balancing many powerful influences, including geo-political conflict, the effects of the pandemic, rampant inflation, supply chain constraints, volatile market gyrations, Federal Reserve policy changes, workforce issues, and a host of other factors in seeking profitable returns. Making sense of the macro trends is a lot to ask of yourself. In this particular Commerce Trust article, we've updated information from a past commentary that offers up some insight on how investors, working with their advisors, might re-examine their underlying motivations and personal psychology in making more rational buy-sell decisions for their portfolios. You may find yourself in this article as we look at core investing habits and behavioral financial biases that influence how we meet our investment goals during periods of change.

Q. SHOULDN'T INVESTORS RELY MOSTLY ON FUNDAMENTALS, FACTS AND FIGURES, ETC., WHEN INVESTING?

A. If the market was only populated with rational investors who were always willing to accept a higher degree of risk for a potential higher return, we could say yes. Certainly, analyzing all factors is important. All we are saying here is that it's also valuable for you to admit to yourself how your particular investment decisions and biases play a role in your thinking. This aspect of investing is referred to as behavioral finance, and it assumes that investors do not always act based on raw facts and analysis conclusion alone. Moreover, based on studies conducted in the late 1970s, researchers found that people normally feel losses twice as bad as they feel the joy of gains. Therefore, behavioral finance argues that investors are irrational and do not always choose or make an optimal decision when given the information due to either an information processing issue or certain biases they possess.

Q. OK, HOW WOULD KNOWING MY OWN BEHAVIORAL FINANCE TENDENCIES HELP ME IN THIS MARKET?

A. Well, currently we are in the midst of a stock market contraction buried in an economy that is overall structurally sound and poised to grow despite all the negative headlines. As such, we think it is important to periodically revisit how investors tend to react when there are significant transitions evolving in the market. How might investment decisions be made now under these conditions and how do these decisions impact your achieving your life goals? Understanding your behavioral finance tendencies might help you not to repeat some costly mistakes, especially if one is in, or close to entering, the retirement phase. If one recognizes bias, investors can try to accommodate for it.

Q. WHAT BEHAVIORAL BIASES ARE INVESTORS PRONE TOWARD?

A. There are four types of behavioral investors: Preservers, Followers, Independents and Accumulators. The four categories are mainly determined by their current stage of life cycle, investable assets and total net worth.

Preservers are typically risk-averse investors who place a much greater importance on the safety of their wealth than taking risks to grow it. Common Preservers gained their wealth through inheritance or saving a large portion of their discretionary income. Some Preservers could be focused with short-term losses more than their desire for the potential long-term investment gains.

Followers are passive investors who do not have their own ideas about investing. They follow the leads of others who they trust and seek the most popular investments, at the time, without a defined long-term plan. Followers often overestimate their risk tolerance and maintain high cash levels.

Independents are risk-taking active investors who are involved in their wealth creation by typically risking their own capital to achieve wealth growth objectives. They also want to be involved in the investment decision making and sometimes conduct their own due diligence on considered investments. They are independent thinkers and do their own research. Nevertheless, they may overlook crucial information from other resources that are not available to them.

Accumulators are risk-seeking active investors who are typically entrepreneurs with high wealth levels and are more strong-willed and confident than Independents. Since they have experienced superior control on other non-investment activities outcomes (such as in their businesses), they believe that they can do the same with investing. This could lead to overconfidence bias and ultimately sub-optimal performance outcomes.

Q. WHAT SPECIFIC BIASES FOR THE AVERAGE INVESTOR DO YOU SEE MOST OFTEN?

A. Some would say it's the artificial accounting "buckets" we arbitrarily create in our heads to sort various sums of money based on where these funds are mentally categorized (retirement

investments, taxable investments, college funds, etc.). These mental buckets can cause investors to neglect allocations that offset, complement, or correlate across your larger holdings and may make overall portfolio performance suffer. For example, in cases where two spouses have 401(k) funds at separate companies, collectively you could have over-concentrated positions in equities because the two spouses treated the funds mentally as two different accounts. In addition, investors tend to invest in an imbalanced fashion when their employer stock is offered in their retirement plans. Investors seem to invest in a much more balanced allocation when their employer stock is not offered. Another bias frequently seen is investors chasing yield with less regards to the investment's merit. Solely chasing income streams can inadvertently erode principal and ultimately the total return on portfolios.

Q. WHY DO INVESTORS REPEAT THESE KINDS OF MISTAKES? DON'T TODAY'S INVESTORS HAVE UNPRECEDENTED ACCESS TO FINANCIAL INFORMATION?

A. Technology has certainly helped in a tremendous fashion. However, some might argue that it also contributes to irrational behavioral of some investors. A recent study showed that people are still easily overwhelmed with information, which leads them to attempt to find shortcuts to arrive at a decision, which can lead to a less optimal outcome. Investing is not a situation where shortcuts and personal "rules of thumb" work over time. Also, the same study found that when people are offered too many options, they tend to do nothing and leave things as is, which could pose tremendous unnecessary risk.

Q. WHAT ADVICE WOULD YOU GIVE INVESTORS TO HELP ACCOMMODATE FOR THEIR BIASES?

A. First, and more than anything else, just try to acknowledge them. Recognize that confusion or frustration naturally arises when an individual receives new information that conflicts with pre-existing beliefs or experiences about an investment they hold. Investors may often hold losing positions to avoid the mental discomfort associated with admitting they made a bad decision. Clinging to prior views or forecasts at the expense of acknowledging new information is another form of bias. But if you recognize it, you can adjust for it.

Q. CAN YOU GIVE ME A SPECIFIC EXAMPLE?

A. Investors who have an emotional attachment to an inherited stock can learn to treat it as equally as another stock that was recently bought. Second, seeking professional investment advice is an effective way to invest based on fundamental facts and analysis and will tremendously lessen the effect of the behavioral biases that could influence investment and ultimately future financial goals. Finally, investments are meant for the long-term in general, and the reality is that even top investment managers experience periods of underperformance when their investment style or philosophy is temporarily out of favor. Nevertheless, these periods of underperformance typically represent golden opportunities to savvy investors to allocate their un-invested excess cash into temporarily undervalued (attractive) investments for the long-term growth they pursue.

Q. WHAT WOULD YOU SUGGEST IN THE NEAR TERM?

Just recognize we are all human and all of us have our own investing styles. Your style many not necessarily be a weakness or a strength. Maybe it comes down to a quote from Socrates, who said, “To know thyself is the beginning of wisdom.” You may discover with an advisor as a partner that you can tap the experiences of both parties in reaching your goals. Making better decisions at any pursuit, especially one involving investments, can add up over time. Touch base with your Commerce Trust Company advisor today if you would like to re-examine your portfolio.

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