RIA Advice

Investor psychology is one of the most significant reasons individuals consistently fall short of their investment goals. While one of the most common truisms is that *"investors buy high and sell low,"* the underlying reason is the behavioral traits that plague our investment decision-making.

George Dvorsky once wrote that:

> *?The human brain is capable of 10^{16} processes per second, which makes it far more powerful than any computer currently in existence.* ***But that doesn?t mean our brains don?t have major limitations.*** *The lowly calculator can do math thousands of times better than we can, and our memories are often less than useless ? plus, we?re subject to* ***cognitive biases, those annoying glitches in our thinking that cause us to make questionable decisions and reach erroneous conclusions.****?*

Behavioral traits and cognitive biases are anathemas to portfolio management as they impair our ability to remain emotionally disconnected from our money. As history all too clearly shows, investors always do the•"opposite"•of what they should when it comes to investing their own money.•They *"buy high"*•as the emotion of *"greed"*•overtakes logic **and•*"sell low"*•as *"fear"*•impairs the decision-making process.**

In other words:

> ***?The most dangerous element to our success as investors?is ourselves.?***

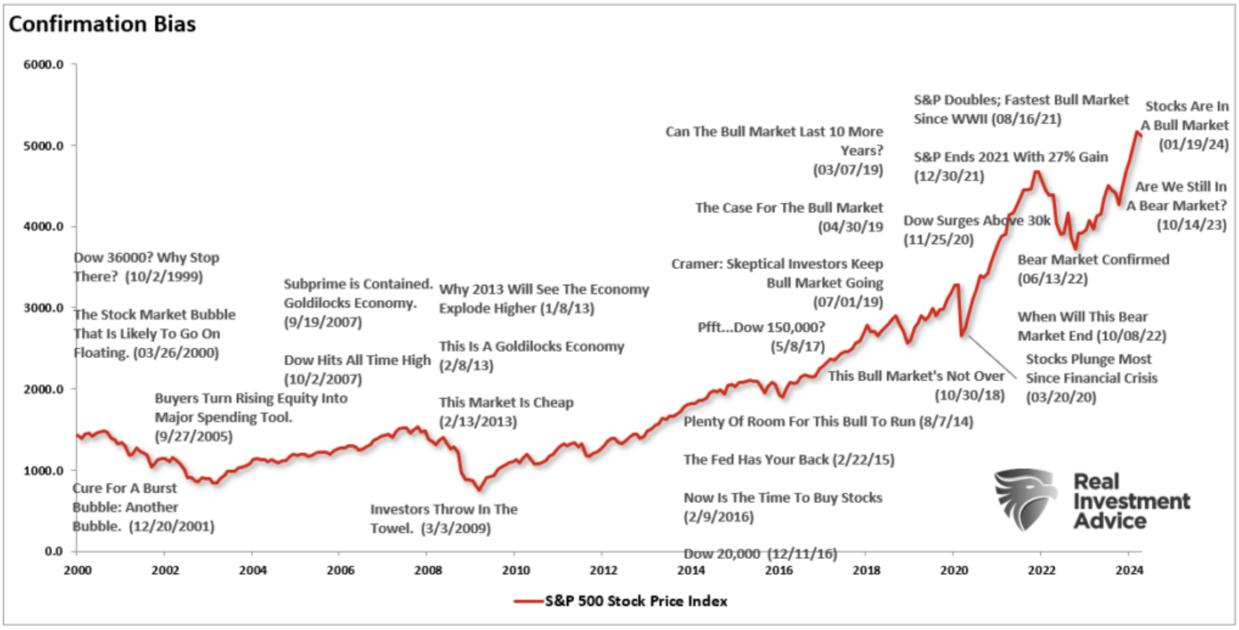
Here are the top five most insidious behavioral traits keeping us from achieving our long-term investment goals.

Confirmation Bias

Probably one of the most insidious behavioral traits is "confirmation bias." Confirmation bias is a term from cognitive psychology that describes how people naturally favor information that confirms their previously existing beliefs.

"Experts in behavioral finance•find that this fundamental principle applies to investors in notable ways. ***Because investors seek out information that confirms their opinions and ignore facts or data that refutes them, they may skew the value of their decisions based on their cognitive biases.****•This psychological phenomenon occurs when•investors•filter out potentially useful facts and opinions contradicting their preconceived notions." - Investopedia*

In other words, investors tend to seek information that confirms their beliefs. If they believe the stock market will rise, they tend only to read news and information that supports that view. This confirmation bias is a primary driver of individuals' psychological investing cycles. As shown below, there are always *"headlines"* from the media to *"confirm"* an investor's opinion, whether it's bullish or bearish.



As investors, we want•*"affirmation"*•that our current thought process is correct. That is why we tend to join groups on social media that confirm our thoughts and ideals. Therefore, since we hate being wrong, **we subconsciously avoid contradicting sources of information.**

For investors, it is crucial to weigh both sides of each debate equally and analyze the data accordingly.

Being right and making money are not mutually exclusive.

Gambler's Fallacy

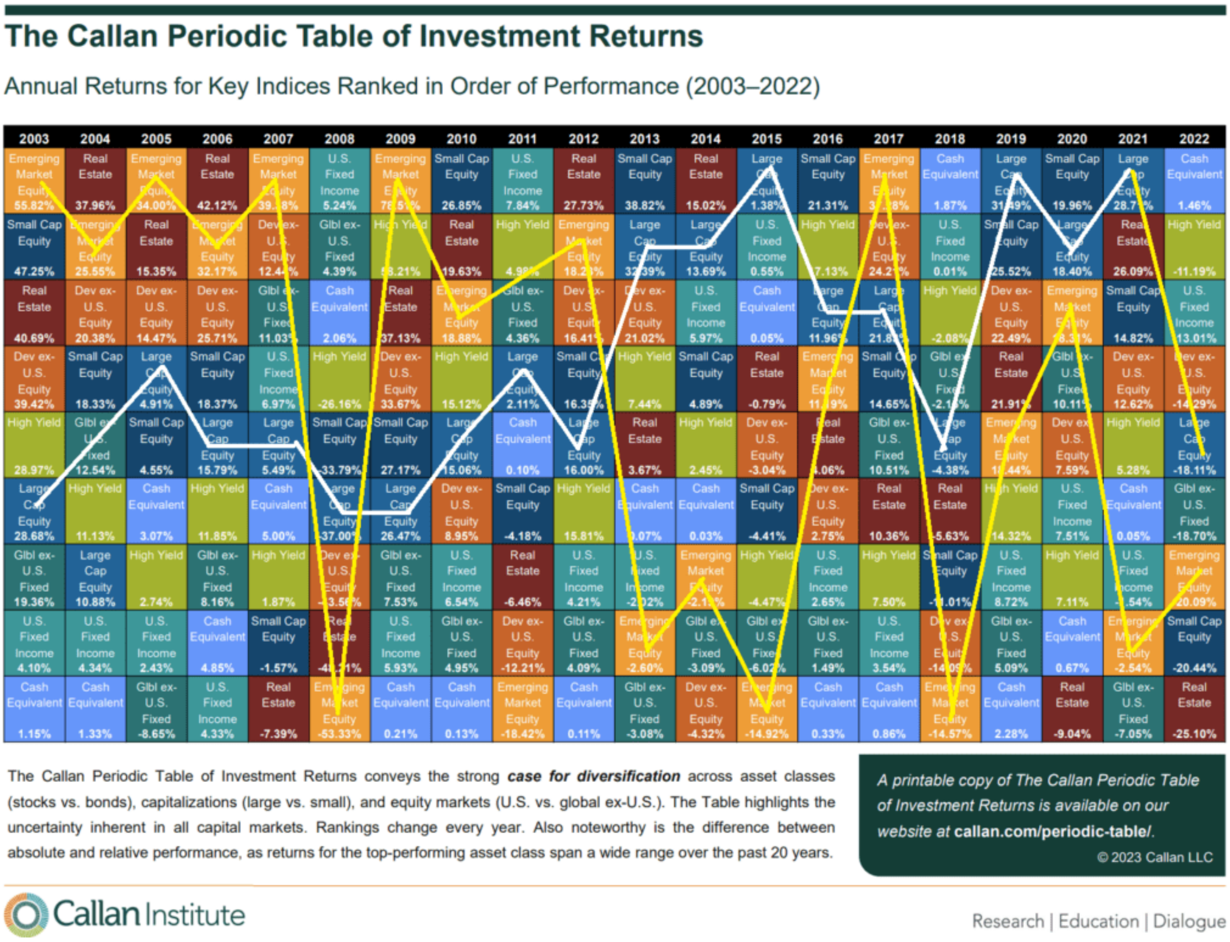
The•*"Gambler's Fallacy"*•is another of the more common behavioral traits. **As emotionally driven human beings, we tend to put tremendous weight on previous events, believing that future outcomes will be the same.**

At the bottom of every piece of financial literature, Wall Street addresses that behavioral trait.

> ***?Past performance is no guarantee of future results.?***

However, despite that statement being plastered everywhere in the financial universe, individuals consistently dismiss the warning and focus on past returns, expecting similar results in the future.

This particular behavioral trait is a critical issue affecting investors' long-term returns. **Performance chasing has a high propensity to fail, pushing** individuals to jump from one late-cycle strategy to the next.•The periodic table of returns below shows this. Historically,*"hot hands"*•last 2-3 years before going•*"cold."*



The Callan Periodic Table of Investment Returns

Annual Returns for Key Indices Ranked in Order of Performance (2003–2022)

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Emerging Market Equity 55.82%	Real Estate 37.96%	Emerging Market Equity 34.00%	Real Estate 42.12%	Emerging Market Equity 39.38%	U.S. Fixed Income 5.24%	Emerging Market Equity 78.51%	Small Cap Equity 26.85%	U.S. Fixed Income 7.84%	Real Estate 27.73%
Small Cap Equity 47.25%	Emerging Market Equity 25.55%	Real Estate 15.35%	Emerging Market Equity 32.17%	Dev ex-U.S. Equity 12.44%	Glbl ex-U.S. Fixed 4.39%	High Yield 58.21%	Real Estate 19.63%	High Yield 4.98%	Emerging Market Equity 18.23%
Real Estate 40.69%	Dev ex-U.S. Equity 20.38%	Dev ex-U.S. Equity 14.47%	Dev ex-U.S. Equity 25.71%	Glbl ex-U.S. Fixed 11.03%	Cash Equivalent 2.06%	Real Estate 37.13%	Emerging Market Equity 18.88%	Glbl ex-U.S. Fixed 4.36%	Dev ex-U.S. Equity 16.41%
Dev ex-U.S. Equity 39.42%	Small Cap Equity 18.33%	Large Cap Equity 4.91%	Small Cap Equity 18.37%	U.S. Fixed Income 6.97%	High Yield -26.16%	Dev ex-U.S. Equity 33.67%	High Yield 15.12%	Large Cap Equity 2.11%	Small Cap Equity 16.35%
High Yield 28.97%	Glbl ex-U.S. Fixed 12.54%	Small Cap Equity 4.55%	Large Cap Equity 15.79%	Large Cap Equity 5.49%	Small Cap Equity -33.79%	Small Cap Equity 27.17%	Large Cap Equity 15.06%	Cash Equivalent 0.10%	Large Cap Equity 16.00%
Large Cap Equity 28.68%	High Yield 11.13%	Cash Equivalent 3.07%	High Yield 11.85%	Cash Equivalent 5.00%	Large Cap Equity -37.00%	Large Cap Equity 26.47%	Dev ex-U.S. Equity 8.95%	Small Cap Equity -4.18%	High Yield 15.81%
Glbl ex-U.S. Fixed 19.36%	Large Cap Equity 10.88%	High Yield 2.74%	Glbl ex-U.S. Fixed 8.16%	High Yield 1.87%	Dev ex-U.S. Equity -43.56%	Glbl ex-U.S. Fixed 7.53%	U.S. Fixed Income 6.54%	Real Estate -6.46%	U.S. Fixed Income 4.21%
U.S. Fixed Income 4.10%	U.S. Fixed Income 4.34%	U.S. Fixed Income 2.43%	Cash Equivalent 4.85%	Small Cap Equity -1.57%	Real Estate -48.21%	U.S. Fixed Income 5.93%	Glbl ex-U.S. Fixed 4.95%	Dev ex-U.S. Equity -12.21%	Glbl ex-U.S. Fixed 4.09%
Cash Equivalent 1.15%	Cash Equivalent 1.33%	Glbl ex-U.S. Fixed -8.65%	U.S. Fixed Income 4.33%	Real Estate -7.39%	Emerging Market Equity -53.33%	Cash Equivalent 0.21%	Cash Equivalent 0.13%	Emerging Market Equity -18.42%	Cash Equivalent 0.11%

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Small Cap Equity 38.82%	Real Estate 15.02%	Large Cap Equity 1.38%	Small Cap Equity 21.31%	Emerging Market Equity 37.28%	Cash Equivalent 1.87%	Large Cap Equity 31.49%	Small Cap Equity 19.96%	Large Cap Equity 28.71%	Cash Equivalent 1.46%
Large Cap Equity 32.39%	Large Cap Equity 13.69%	U.S. Fixed Income 0.55%	High Yield 17.13%	Dev ex-U.S. Equity 24.21%	U.S. Fixed Income 0.01%	Small Cap Equity 25.52%	Large Cap Equity 18.40%	Real Estate 26.09%	High Yield -11.19%
Dev ex-U.S. Equity 21.02%	U.S. Fixed Income 5.97%	Cash Equivalent 0.05%	Large Cap Equity 11.96%	Large Cap Equity 21.83%	High Yield -2.08%	Dev ex-U.S. Equity 22.49%	Emerging Market Equity 18.31%	Small Cap Equity 14.82%	U.S. Fixed Income -13.01%
High Yield 7.44%	Small Cap Equity 4.89%	Real Estate -0.79%	Emerging Market Equity 11.19%	Small Cap Equity 14.65%	Glbl ex-U.S. Fixed -2.15%	Real Estate 21.91%	Glbl ex-U.S. Fixed 10.11%	Dev ex-U.S. Equity 12.62%	Dev ex-U.S. Equity -14.29%
Real Estate 3.67%	High Yield 2.45%	Dev ex-U.S. Equity -3.04%	Real Estate 4.06%	Glbl ex-U.S. Fixed 10.51%	Large Cap Equity -4.38%	Emerging Market Equity 18.44%	Dev ex-U.S. Equity 7.59%	High Yield 5.28%	Large Cap Equity -18.11%
Cash Equivalent 0.07%	Cash Equivalent 0.03%	Small Cap Equity -4.41%	Dev ex-U.S. Equity 2.75%	Real Estate 10.36%	Real Estate -5.63%	High Yield 14.32%	U.S. Fixed Income 7.51%	Cash Equivalent 0.05%	Glbl ex-U.S. Fixed -18.70%
U.S. Fixed Income -2.02%	Emerging Market Equity -2.19%	High Yield -4.47%	U.S. Fixed Income 2.65%	High Yield 7.50%	Small Cap Equity -11.01%	U.S. Fixed Income 8.72%	High Yield 7.11%	U.S. Fixed Income -1.54%	Emerging Market Equity -20.09%
Emerging Market Equity -2.60%	Glbl ex-U.S. Fixed -3.09%	Glbl ex-U.S. Fixed -6.02%	Glbl ex-U.S. Fixed 1.49%	U.S. Fixed Income 3.54%	Dev ex-U.S. Equity -14.09%	Glbl ex-U.S. Fixed 5.09%	Cash Equivalent 0.67%	Emerging Market Equity -2.54%	Small Cap Equity -20.44%
Glbl ex-U.S. Fixed -3.08%	Dev ex-U.S. Equity -4.32%	Emerging Market Equity -14.92%	Cash Equivalent 0.33%	Cash Equivalent 0.86%	Emerging Market Equity -14.57%	Cash Equivalent 2.28%	Real Estate -9.04%	Glbl ex-U.S. Fixed -7.05%	Real Estate -25.10%

The Callan Periodic Table of Investment Returns conveys the strong ***case for diversification*** across asset classes (stocks vs. bonds), capitalizations (large vs. small), and equity markets (U.S. vs. global ex-U.S.). The Table highlights the uncertainty inherent in all capital markets. Rankings change every year. Also noteworthy is the difference between absolute and relative performance, as returns for the top-performing asset class span a wide range over the past 20 years.

A printable copy of The Callan Periodic Table of Investment Returns is available on our website at ***callan.com/periodic-table/****.*

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I highlighted the annual returns of both Emerging and Large-Cap markets for illustrative purposes.• **Importantly, you should notice that whatever is at the top of the list in some years tends to fall to the bottom in subsequent years.•**

"Performance chasing"•is a significant detraction from investors' long-term investment returns.

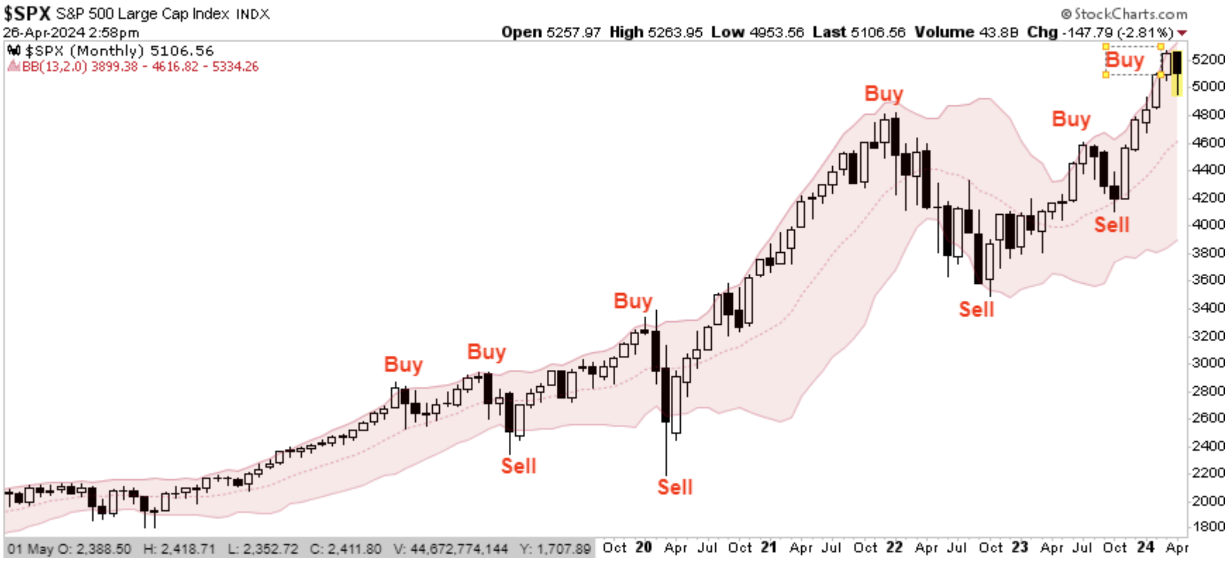
Probability Neglect

Third, when it comes to•*"risk-taking,"*•there are two ways to assess the potential outcome.

There are•*"possibilities"*•and•*"probabilities."*•

When it comes to humans, we tend to lean toward what is•possible,•such as playing the •*"lottery."* The statistical probabilities of winning the lottery are astronomical. You are more likely to die on the way to purchasing the ticket than winning it.•**However, it is the•*"possibility"*•of being fabulously wealthy that makes the lottery so successful as a•*"tax on poor people."***

As investors, we•neglect•the•*"probabilities"*•of any given action. Such is specifically the statistical measure of•*"risk"*•undertaken with any given investment.•As individuals, our behavioral trait is to•*"chase"*•stocks that have already shown the largest increase in price as it is• *"possible"*•they could move even higher. However, the•*"probability"*•is that the price reflects investor exuberance, and most gains have already occurred.



Probability neglect is another contributory factor as to why investors consistently•*"buy high and sell low."*

Herd Bias

Though we are often unconscious of this particular behavioral trait,**humans tend to•*"go with the crowd."*•**Much of this behavior relates to•"confirmation"•of our decisions and the need for acceptance. The thought process is rooted in the belief that if *"everyone else"* is doing something, I must do it also if I want to be accepted.

In life, "conforming" to the norm is socially accepted and, in many ways, expected. However, the *"herding"* behavior drives market excesses during advances and declines in the financial markets.

As Howard Marks once stated:

> *?Resisting ? and thereby achieving success as a contrarian ? isn?t easy.* ***Things combine to make it difficult; including natural herd tendencies and the pain imposed by being out of step, since momentum invariably makes pro-cyclical actions look correct for a while.*** *(That?s why it?s essential to remember that ?being too far ahead of your time is indistinguishable from being wrong.?*
>
> ***Given the uncertain nature of the future, and thus the difficulty of being confident your position is the right one ? especially as price moves against you ? it?s challenging to be a lonely contrarian.****?*

Investors generate the most profits in the long term by moving against the *"herd."* Unfortunately, most individuals have difficulty knowing when to•*"bet"*•against the stampede.

Anchoring Effect

Lastly, *"Anchoring,"* also known as the•*"relativity trap,"*•is the tendency to compare our current situation within the scope of our limited experiences. For example, I would be willing to bet that you could tell me exactly what you paid for your first home and what you eventually sold it for. **However, can you tell me exactly what you paid for your first soap bar, hamburger, or pair of shoes? Probably not.**

The reason is that the home purchase was a major "life" event. Therefore, we attach particular significance to that event and remember it vividly. If there was a gain between the purchase and sale price of the home, it was a positive event, and therefore, we assume that the next home purchase will have a similar result. **We are mentally *"anchored"* to that event and base our future decisions around very limited data.**

When it comes to investing, we do very much the same thing. If we buy a stock that goes up, we remember that event. Therefore, we become anchored to that stock instead of one that lost value. **Individuals tend to *"shun"* stocks that lost value even if they were bought and sold at the wrong times due to investor error.**

After all, it is not *"our"* fault that the investment lost money; it was just a bad stock. Right?

Make Better Bad Choices

My nutrition coach had a great saying about dieting; *"make better bad choices."*

We are all going to make bad choices from time to time. The goal is to try and make bad choices that don't have an outsized effect on our plan. When it comes to dieting, if you eat a burger, order it without cheese and mayonnaise.

If you make speculative bets in your portfolio, do it in smaller amounts. Or, if you are leaning towards *"panic selling"* everything, start by selling some but not all of your holdings.

Importantly, focus on the rules and your investment discipline.

- ***Do more of what is working and less of what isn't.***
- *Remember that the "Trend Is My Friend."*
- ***Be either bullish or bearish, but not "hoggish." (Hogs get slaughtered)***
- *Remember, it is "Okay" to pay taxes.*
- *Maximize profits by staging buys, working orders, and getting the best price.*
- ***Look to buy damaged opportunities, not damaged investments.***
- *Diversify to control risk.*
- ***Control risk by always having pre-determined sell levels and stop-losses.***
- *Do your homework.*
- ***Not allow panic to influence buy/sell decisions.***
- *Remember that "cash" is for winners.*
- *Expect, but do not fear, corrections.*
- ***Expect to be wrong, and will correct errors quickly.***
- *Check "hope" at the door.*
- ***Be flexible.***
- *Have the patience to allow your discipline and strategy to work.*
- ***Turn off the television, put down the newspaper, and focus on your analysis.***

Importantly, keep your market perspectives and behavioral traits in check. Our goal is to ensure that our decisions are influenced by reliable data and psychological emotions.

Most importantly, if you don't have an investment strategy and discipline you are stringently following, that is an ideal place to begin.