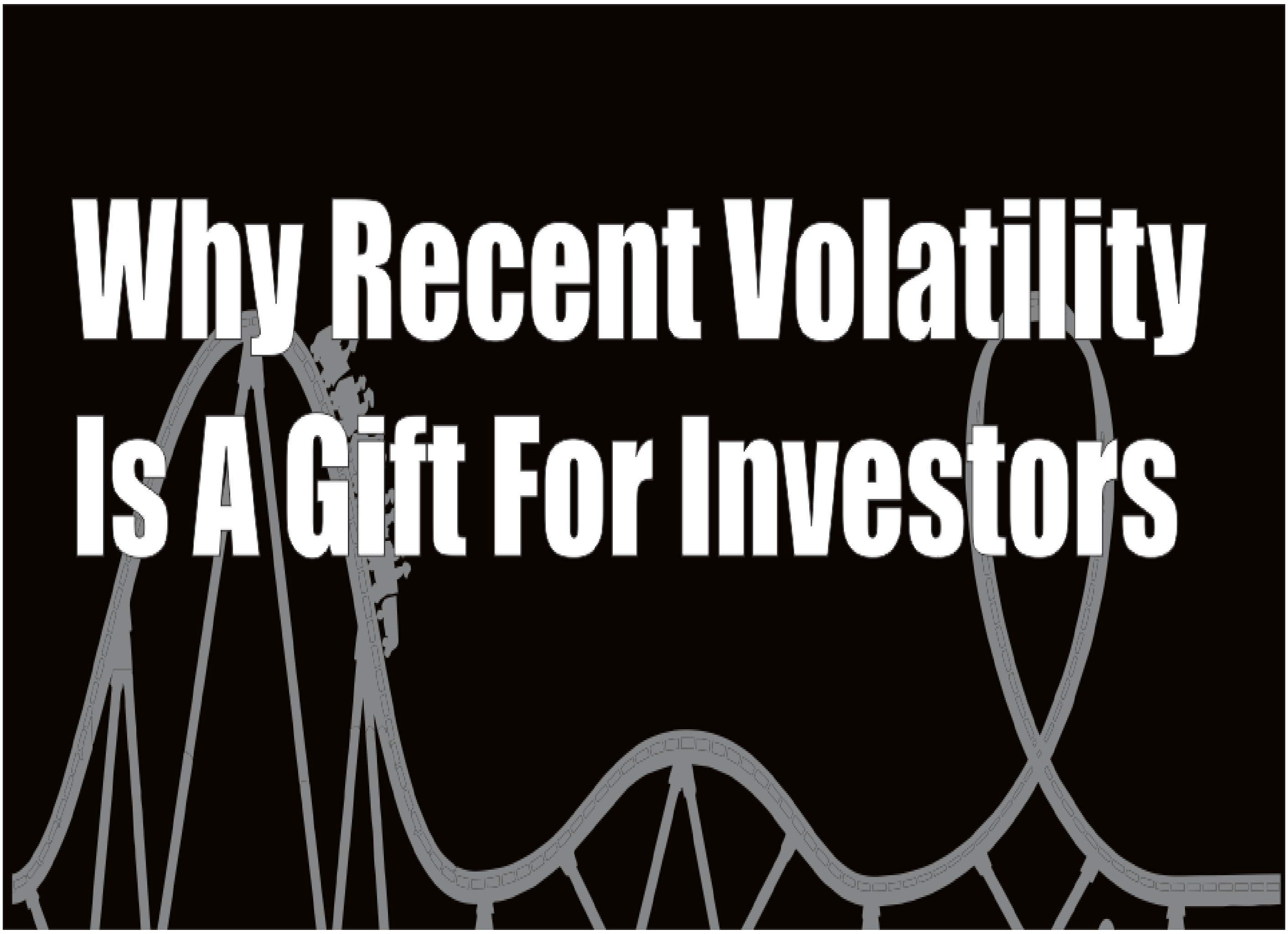
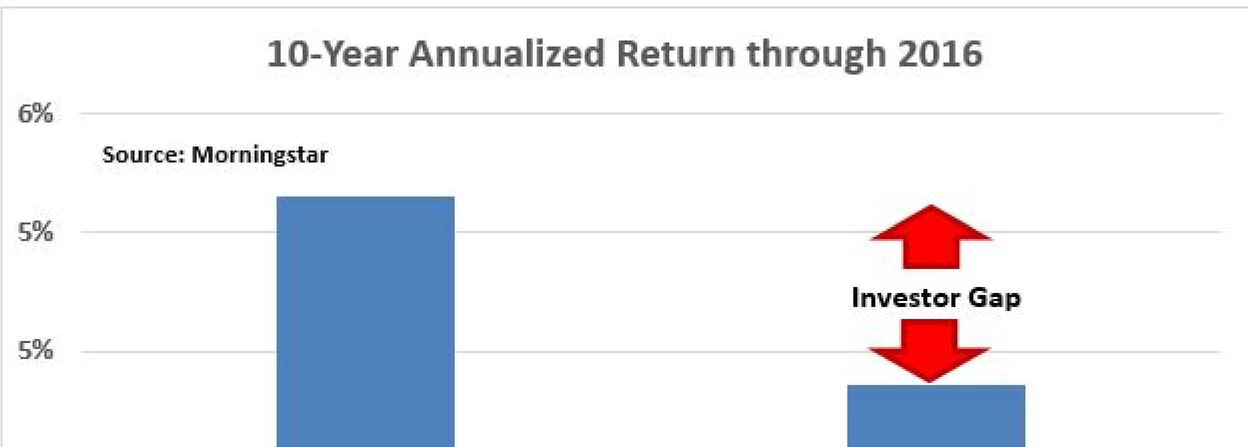


Warren Buffett?s teacher, Benjamin Graham, once wrote:

> *?The investors chief problem ? and even his worst enemy ? is likely to be himself.?*

The market?s recent volatility can give investors an opportunity to reflect on some common psychological pitfalls and not be their own worst enemies. Investors damage themselves mostly by selling stocks when they get cheap and buying them when they get expensive. Morningstar?s most recent investor returns study shows that investors in diversified stock funds are giving up nearly one percentage point of returns annually due to bad trading. While the numbers don?t tell us what?s causing investors to lag the returns of their funds, it may well be due to certain behavioral problems. Advisors see the behavior constantly in their practices. And advisors aren?t immune from the behavior themselves.



Damaging though it can be, it?s understandable why investors sell low and buy high. Nobody likes to see their portfolio declining, so the inclination is to sell when stocks are going down. And nobody likes to see their neighbor making more money than they are, so the inclination is to buy when stocks are going up. The fear of losing money permanently and the fear of missing out on gains (which may really be just greed) are always at play. •Of course, if you?re supposed to adhere to a target allocation, you must sell when stocks go up to maintain your allocation. And you must buy when stocks go down to maintain your allocation. But investors forget that in times of euphoria or panic. Sometimes being in the right parts of the market can help, whether you?ve emphasized the right sectors or the right parts of the world. But, as this Morningstar article notes, there were few places to hide during the stock market?s recent unpleasantness. And that may be the case next time as well, since all asset classes seem to have risen in tandem after the financial crisis. That leaves the question of owning more bonds. From February 1st through February 9th the S&P 500 Index dropped around 7%, not including dividends. Over that period, the iShares 10-20 Year Treasury Bond ETF (TLH) lost only around 1% in price ? a considerable improvement over stocks. And, of course, cash didn?t lose anything.

An Opportunity To Reassess Risk Tolerance & Allocation

The lesson investors should take from the recent market turbulence is to think about whether it frightened them and how much it frightened them. After all, an investor?s bias should be to buy when the market is going down. That?s not to say the roughly one-week correction we had is all the downside we?ll see, and that buying stocks while it was happening would have guaranteed rock-bottom purchase prices. But an investor should be inclined to buy when markets are falling, not sell. Similarly, the bias should be toward trimming stock from a portfolio during market surges. Use the recent turbulence to take the temperature of your emotions. What were you inclined to do when you saw your portfolio?s value declining? When investors complete the risk questionnaires that their advisors give them, it?s difficult for them to remember how they felt during the last bear market. Behavioral finance calls the inability to access old feeling the ?empathy gap.? As a result, many investors indicate on risk profile questionnaires that they are more risk-tolerant than they really are. Don?t? squander the gift last week?s recovery gave you to think about how the week before felt. If you wanted desperately to sell, you probably have the wrong allocation. I talked to an investor during the correction whose portfolio was down around 5%. We surmised he probably had a balanced ? roughly half stocks and half bonds ? allocation, and that?s normally considered reasonable for his age (early 50s). But he was rather disturbed by this volatility, and we couldn?t help but conclude that his allocation was too aggressive for his personal taste and comfort. Advisors tell clients that a 5% decline isn?t much. It?s really the price of admission into the stock market, which experiences 10% drops with great regularity. That may be true, but many investors don?t realize what it will feel like when they see their account decline. Many investors indicate that they can handle a 20% decline in their portfolios on risk questionnaires. But a 5% decline, after all, will reduce a $500,000 portfolio by $25,000. That?s usually not catastrophic, but it?s unnerving for someone who hasn?t experienced it before. And it can push them to sell stocks at lower prices. A full 20% decline will reduce a $500,000 portfolio by $100,000, and the older you are, the more unnerving that can be. A balanced portfolio (50%-60% in stocks) should a reasonable one for many people 15 years from retirement into early retirement, but many investors are unaccustomed to its volatility, and many advisors are unaware of how unaccustomed their clients are to its volatility. Investors should use this opportunity to decide if they need to reduce their stock exposure, and advisors need to reassess how well they?re preparing clients for inevitable downturns. Advisors don?t like to be negative. They think, with some justice, that negativity will make it harder to attract and retain clients. But they must focus on the downside and educate clients better. It?s arguably their fiduciary duty, and it will make for better client experiences in the long run.

Think In Dollar Terms, Not Percentage Terms

Investors should do at least one more thing in response to the recent volatility. Think in dollar terms, not percentage terms. Most investors don?t know what a 5%, 10%, or 20% decline really means for their portfolios. They?re not used to thinking in percentage terms. Go through the exercise of thinking about what each of these declines means in dollar terms for your portfolio. It will help you understand how much risk you?re taking and whether you can tolerate it. We?ve had two 50% top-to-bottom stock market drawdowns within the past 20 years. Valuations are stretched now, and there?s nothing to say we can?t have another one ? though, as always, there?s no certainty that we will have one. The time to prepare is now ? after the gift the market just gave you in dropping a lot, but then recovering a lot.