> *The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only.•*? John Maynard Keynes

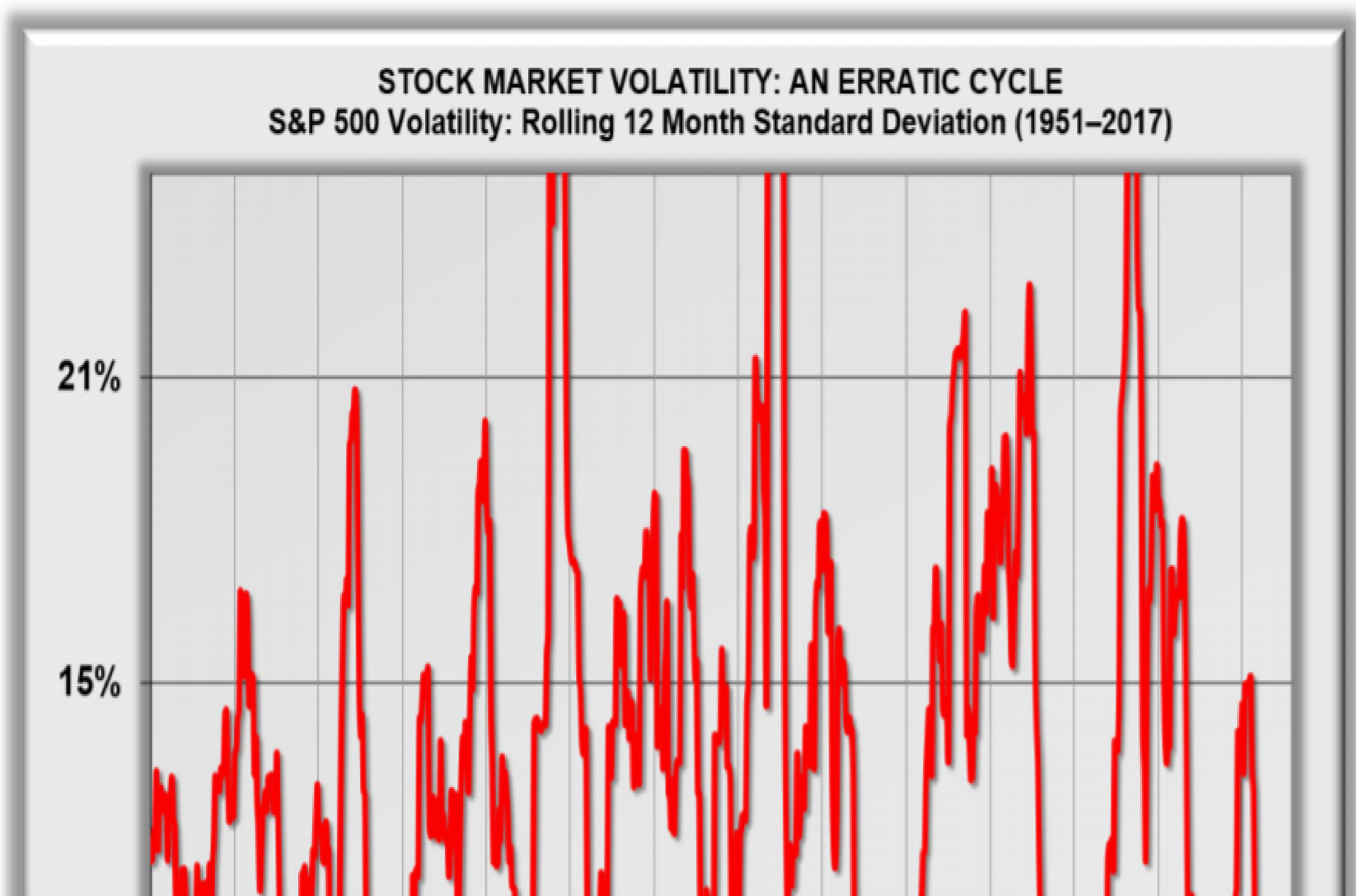
It?s time we expose a few of the greatest financial mismatches in history. At the top of my mind, due to a myriad of behavioral and cognitive hiccups, are select retail investors (you know who you are), who must come to grips with how they?re handling current stock market volatility.

It?s a moment of truth

Too many investors possess a hook-up mentality with stocks. Holding periods are at historic lows. **According to the New York Stock Exchange?s extensive database, the average holding period for stocks in 1960 was 8 years, 4 months. As of December 2016, it was 8.3 months.**

Last year?s unprecedented stock market performance for the S&P 500 was the worst event for investor psyche. I?ll explain. No doubt, it was a magical year. The market closed higher every month (first time in history). [The Sharpe Ratio](), or returns on the S&P relative to the risk-free (Treasury Bills) and volatility was 3.7. Since volatility was non-existent last year, risk-adjusted returns for the market were among the best I ever lived through; at least the highest in over 50 years. Think of it like dating the most popular girl (or guy), in high school. In the beginning, you wonder how the heck it happened. Such luck! Eventually, you believe you?re entitled to dating prom kings and queens in perpetuity. The problem is ego. You convince yourself the perfect prom date is the norm and begin to compare every date after to ?the one.? What a great way to set yourself up for failure, missed opportunities and myopia that slaughters portfolio returns (and possibly, relationships!) In 2017, equity investors witnessed a storybook investment scenario. This year so far? Reality bites. It?s not that your adviser doesn?t know what he or she is doing; it?s not the market doing anything out of the ordinary, either. The nature of the market *is* volatility, jagged edges and fractals. The sojourn, the Sunday drive in perfect weather with the top down on a newly-paved road in 2017, was an outlier. The environment you?re investing through today is the norm; therefore, the problem must be the driver, the investor who doesn?t realize the road conditions are back to resembling 5pm rush-hour in a downpour. Do you experience frustration with a purchase your adviser implements or recommends if the price doesn?t quickly move in your favor? Do you question every move (or lack thereof), a financial partner makes? How often do you say to yourself - *?She didn?t take enough profit. Why did he buy that dog? Why isn?t he or she doing anything? (Sometimes doing nothing is the best strategy, btw).* **Do you constantly compare portfolio performance every quarter with a stock market index that has nothing to do with returns required to meet a personalized benchmark or long-term goal like retirement?** Ostensibly, the ugly truth is there may be a mismatch between your brain and your brain on investments. Listen, stocks aren?t for everyone. Bonds can be your worst enemy. Even the highest quality bond fluctuates and can be sold at a loss before maturity. This is the year as an investor you?re going to need to accept that volatility is the entrance fee to play this investment game. According to Crestmont Research, volatility for the S&P 500 tends to average near 15%. However, volatile is well, volatile. Most periods generally fall within a band of 10% to 20% volatility with pockets of unusually high and low periods.

igure 1. S&P 500 Index Volatility: Rolling Volatility (1950 to Present)



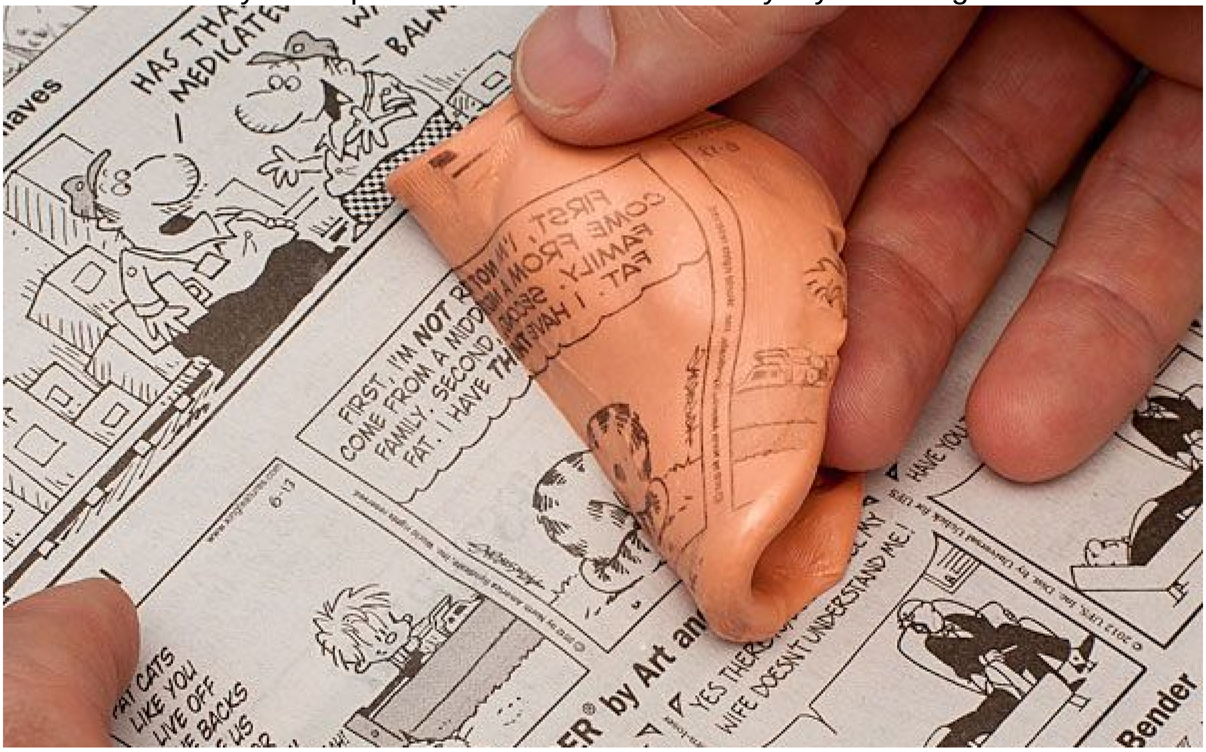
The space between gray lines represents four-year periods. Observe how volatility collapsed in 2017, lower than it?s been in this decades-long series. Per Crestmont:

> *"High or rising volatility often corresponds to declining markets; low or falling volatility is associated with good markets. Periods of low volatility are reflections of a good market, not a predictor of good markets in the future."*

So, as an investor, what are the greatest financial mismatches you?ll face today?

Recency Bias

Recency bias or *?the imprint,?* as I call it, is a cognitive affliction that convinces me the trade I made last Thursday should work like it did when I placed a trade on a Thursday in 2017 when the highway was glazed smooth for max-market performance velocity. This cognitive hiccup deep in my brain makes me predisposed to recall and be seduced by incidents I?ve observed in the recent past. **The imprint of recent events falsely forms the foundation of everything that will occur in the present and future *(at least in my head).*** Recency bias is a mental master and we are slaves to it. It?s human. It?s the habit we can?t break *(hey, it works for me).* In my opinion, recency bias is what separates traders from long-term owners of risk assets. When you allow volatility to deviate you from rules or a process of investing, think about Silly Putty. Remember Silly Putty? Your brain on recency bias operates much like this clammy mysterious goo.



Consider the market conditions. The brain attaches to recent news, preconceived notions or the financial pundit commentary comic-of-the-day and believes these conditions will not change. To sidestep this bias, at Clarity and RIA we adhere to rules, a process to add or subtract portfolio positions. **Unfortunately, rules do not prevent market losses. Rules are there to manage risk in *long-term portfolio allocations.***

> *Losses are to be minimized but if you?re in the stock market you?re gonna experience losses. They are inevitable. It?s what you do (or don?t do), in the face of those losses that define you. And if you?re making those decisions based on imprinting or Silly Putty thinking, you are not cognitively equipped to own stocks.*

Hindsight Bias

When you question your adviser?s every trade or the big ones you personally missed, you?re suffering from hindsight bias. Hindsight bias is deception. You falsely believe the actual outcome had to be the only outcome when in fact an infinite number of outcomes had as equal a chance. **It?s the ego run amok. An overestimation of an ability to *predict the future.*** The market in the short-term is full of surprises. A financial partner doesn?t possess a crystal ball. For example, to keep my own hindsight bias under control, I never take credit for an investment that works gainfully for a client. The market must be respected. Investors, pros or not, must remain humble and in infinite awe of Mr. Market. A winning trade in the short term is luck or good timing. Nothing more. With that being said, stock investing is difficult. Unlike the pervasive, cancerous dogma communicated by money managers like Ken Fisher who boldly states that in the long-run, stocks are safer than cash, stocks are not less risky the longer you hold them. Unfortunately, academic research that contradicts the Wall Street machine rarely filters down to retail investors. One such analysis is entitled *?On The Risk Of Stocks In The Long Run,?* by prolific author Zvi Bodie, the Norman and Adele Barron Professor of Management at Boston University. I had a once-in-a-lifetime opportunity to break bread with Dr. Bodie recently in Nashville and spend quality time picking his brain. I?m grateful for his thoughts. He expressed lightheartedly how his retail books don?t get much attention although the textbook Financial Economics co-written with Robert C. Merton and David L. Cleeton is the one of choice in many university programs. In a joking manner, he calls Wharton School professor and author of the seminal tome *?Stocks for the Long Run,?* Jeremy Siegel his *?nemesis.?* He mentions his goal is to help *"everyday"* people invest, understand personal finance and be wary of the financial industry?s entrenched stories about long-term stock performance. He?s a man after my own heart. He?ll be interviewed on the Real Investment Hour in early June. In the study, he busts the conventional wisdom that riskiness of stocks diminishes with the length of one?s time horizon. The basis of Wall Street?s counter-argument is the observation that the longer the time horizon, the smaller the probability of a shortfall. Therefore, stocks are less risky the longer they?re held. In Ken Fisher?s opinion, stocks are less risky than the risk-free rate of interest (or cash) in the long run. Well, then it should be plausible for the cost of insuring against earning less than the risk-free rate of interest to *decline as the length of the investment horizon increases.* Dr. Bodie contends the probability of a shortfall is a flawed measure of risk because it completely ignores *how large the potential shortfall might be.* Sound familiar? It should. We write of this dilemma frequently here on the blog. Using the probability of a shortfall as the measure of risk, no distinction is made between a loss of 20% or a loss of 99%. **If it were true that stocks are less risky in the long run, it should portend to a lower cost to insure against that risk the longer the holding period. The opposite is true. Dr. Bodie uses modern option pricing methodology i.e., put options to validate the truth.** Using a simplified form of the Black-Scholes formula, he outlines how the cost of insurance rises with time. For a one-year horizon, the cost is 8% of the investment. For a 10-year horizon it is 25%, for a 50-year time frame, the cost is 52%. As the length of horizon increases without limit, the cost of insuring against loss approaches 100% of the investment. The longer you hold stocks the greater a chance of encountering tail risk. That?s the bottom line (or your bottom is eventually on the line). **Short-term, emotions can destroy portfolios; long term, it?s the ever-present possibility of tail risks or *?Black Swans.?*** I know. Tail risks like market bubbles and financial crises don?t come along often. However, only one is required to blow financial plans out of the water. An investor *(if he or she decides to take on the responsibility)*, must follow rules to manage risk of long-term positions that include taking profits or an outright reduction to stock allocations. It?s never an *?all-or-none?* premise. Those who wholesale enter and exit markets based on *?gut?* feelings or are convinced the stocks have reached a top or bottom and act upon those convictions are best to avoid the stock market altogether.