HOW INVESTOR BEHAVIOR INFLUENCES PORTFOLIO PERFORMANCE

Overview

The concept of efficient markets rests on the belief that investors behave rationally — buying when prices are low and selling when they are high. However, that practice goes against the grain of human behavior.

We are not machines; our behavior frequently is based on our emotional reactions. How we respond can vary based on a number of factors, such as market volatility, what's going on in our personal lives and even the mood we're in that day. Unlike when feelings negatively affect our decisions at home or work, an irrational investment choice can't be erased by an apology or change in behavior. Only a shift in the markets can get your stock investment back at its previous price.

Researchers began studying how our cognitive biases, behavioral reactions, lack of self-control and a host of other psychological tendencies impact not just individual investment decisions but the market as a whole. This area of study is called behavioral finance.

Everyone has a set of biases that affect the way they think, feel and act. The same applies when it comes to investing, and when personal preferences infiltrate financial decisions, the impact can be detrimental and potentially long-lasting.

Evidence of Behavioral Influence

In 2015, a study by the financial services research firm Dalbar showed the average investor failed to achieve comparable market-index returns. While the S&P 500 returned 13.69% over the study period, the average equity mutual fund investor earned only 5.50%. Furthermore, the average fixed-income mutual fund investor underperformed the bond market by 4.18%.[1]

Why would this happen? One reason is because investment decisions are influenced by a wide range of factors, beyond just market and company fundamentals. This branch of study has identified the following distinct areas of personal behavioral influence.

Recency Bias
Recency bias is when an investor places greater weight on their most recent experience rather than historical measures of past performance. For example, an investor may assume the current market price of a stock is an accurate measure of the company's performance without taking into account any influence of market trends, economic events or even news headlines. Thus, they abandon market fundamentals associated with long-term averages and probabilities. This may cause them to either sell when prices are low or hold onto a security when its fundamentals have actually changed for the worse.[2]

Anchoring
Anchoring tends to happen when an investor is trying to avoid a loss by hanging on to a declining investment until it returns to the price at which it was purchased. He or she is "anchored" to that price. However, this emotional response could mean significant losses because it overshadows other factors, such as fundamental changes in the company that have led to the price drop.

Investor Regret Theory
We hate being wrong. We hate admitting we made an error in judgement and the feeling of regret that comes with having to change course. As a result, we often drag our feet to avoid facing the consequences. To put this into investment terms, when an investment declines, we may hesitate selling it to avoid feeling regret over a bad decision.

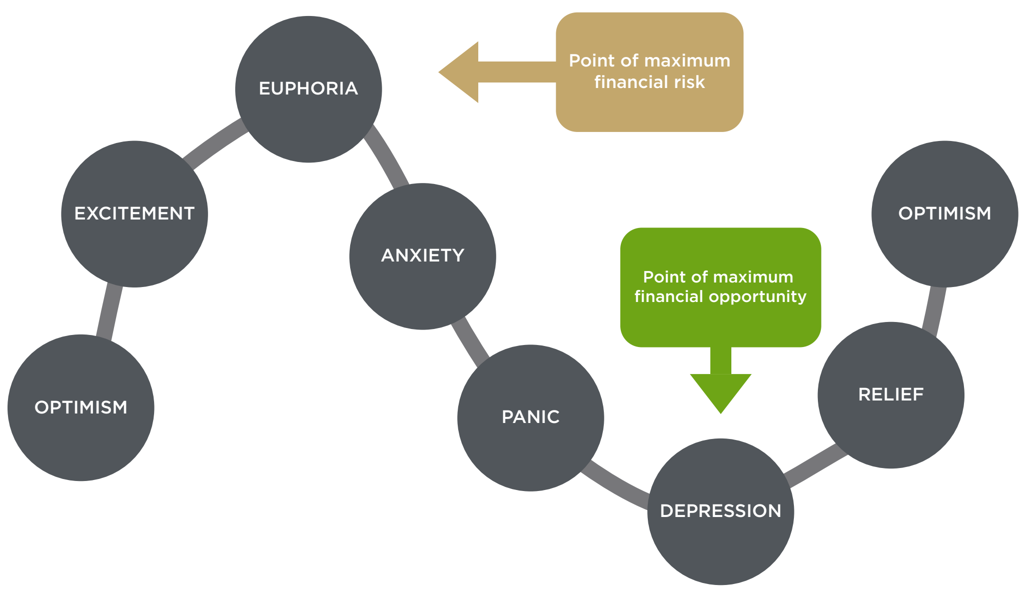
Bear in mind this is how gamblers rack up extensive debt. Rather than walk away after a losing hand, they may double down on the next hand to try recouping what they already lost.

Loss Aversion
The theory of loss aversion is based on the premise that the pain of losing money is more powerful than the pleasure of achieving gains. Aversion to loss causes many investors to invest too conservatively for their goals to avoid short-term market fluctuations. This emotion-based decision can result in a portfolio not even keeping pace with inflation, let alone achieving long-term goals.

Irrational Behavior
When investors watch their portfolios too carefully, they tend to react more dramatically than if they check them only every so often. Irrational behavior occurs in a couple of different ways. First, if an investment is outperforming, the investor may get excited and decide to buy more of it. Unfortunately, that may lead to buying a stock at the height of its market price, which is ill-advised.

On the other side of the coin, when prices drop, investors may be so aggrieved they sell quickly to avoid additional losses. In extreme cases, when irrational behavior affects a wide swath of investors, it can lead to a market bubble (artificially inflated stock prices) or panic selling and a subsequent market crash.

How Irrational Behavior Can Run Counter To Market Cycles[3]



Behavior Finance Investing Tips

The following tips are designed to help mitigate the impact of inherent investor behaviors that can seriously damage the long-term performance of an investment portfolio.

Strategic Asset Allocation
The key to choosing investments is to first determine your goals. Few investors are simply looking to earn lots of money. They actually have objectives for how they intend to use the money they accumulate, such as buying a home, paying for their children's college education or providing income during retirement. Asset allocation is the tactic of determining how much money to allot to different asset classes (e.g., stocks, bonds, cash instruments). Each asset class is generally associated with a risk-and-reward timeframe for delivering best performance.

A financial advisor can help an investor match the appropriate percentage of money to invest across different asset classes based on the investor's tolerance for market risk and the time frame for achieving personal goals. Developing a strategic asset allocation designed to meet specific objectives takes the emotion out of the day-to-day buy-and-sell decisions so that a portfolio has the time to do what it's supposed to do.

Diversification
When an investor maintains a diversified portfolio, it's not likely any one investment will tank his finances or create exorbitant wealth. Spreading out assets and maintaining that allocation over the long haul can help smooth out the dips of market fluctuations that tend to elicit emotional responses.

Scheduled Rebalancing
One way to offset the impact of regret and loss aversion is to schedule the rebalancing of a portfolio at least once a year. This may require selling winning positions and buying into declining positions in order to maintain strategic asset allocation. This helps remove the emotion that might accompany it and aligns with the efficient market theory of buying low and selling high.

"Behaviorists will argue investors often behave irrationally, producing inefficient markets and mispriced securities, not to mention opportunities to make money." [4]

Final Thoughts

It's human nature to react to positive and negative things that happen. We are not robots, and we can't always control the emotions we feel. However, it's important to maintain control of our actions, regardless of the stimuli. Experts believe that recognizing our feelings and controlling our subsequent reactions can not only impact our own portfolios but the performance of the broader market as well.

While efficient markets are designed to buy low and sell high, it's impossible to consistently time the market to do this successfully. Trying to predict market directions frequently leads to irrational behavior, portfolio losses and unnecessary stress. Working with an experienced financial advisor is an effective way to mitigate emotion-driven market reactions.

Financial advisors make recommendations based on your stated goals and objectives, not "hot tips." By working with an advisor to develop a long-term strategy, investors can avoid many of the mistakes that occur in reaction to market swings. An advisor can address your concerns and help you maintain a consistent, long-term investment portfolio with techniques such as systematic investing, portfolio rebalancing and tactical allocation adjustments.

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[1] Cathy Pareto. Investopedia. May 17, 2019. "Understanding Investor Behavior." https://www.investopedia.com/articles/05/032905.asp. Accessed Oct. 15, 2019.
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[3] John Boardman. Ballast Plan. "Behavioral Finance and Asset Allocation." https://ballastplan.com/behavioral-finance-and-asset-allocation/. Accessed Oct. 15, 2019.
[4] Cathy Pareto. Investopedia. May 17, 2019. "Understanding Investor Behavior." https://www.investopedia.com/articles/05/032905.asp. Accessed Oct. 15, 2019.