On Course Financial Planning
Facing the Future with Optimism and Courage
October 2019
Vectors

geo@oncoursefp.com
425-861-9997

Bad Behavior

Investing is an activity that affects your emotions. Your emotional reactions to the latest headlines can have a greater impact on your financial future than the performance of the funds you own. An essential part of any financial advisor's value proposition is preventing clients from making emotionally driven, counterproductive investment decisions and encouraging them to remain focused on their long-term goals.

Classical theories of investor behavior assume that people act rationally and consider all available information before making investment decisions. Behavioral finance makes no such assumptions. It uses psychology to explain why investors repeatedly make the same behavioral mistakes that hinder investment success. Charles Schwab reported the results of its July 2019 survey of more than 300 financial advisors who were asked to identify the most common behavioral mistakes made by their clients.

Recency bias is the most common client behavioral mistake noted by advisors. Each day, the financial media overloads us with information that has very little to do with long-term investing. When faced with information that is too overwhelming to absorb or comprehend, we tend to use decision-making shortcuts called "heuristics". One of the most common heuristics is to assume that the future will look like the recent past. Recency bias often leads to performance chasing; a classic destroyer of investor wealth.

Loss aversion is the second most common behavioral mistake noted by advisors. Loss aversion doesn't mean that people don't enjoy losing money – that's a normal attitude to have. Rather, loss aversion refers to our tendency to avoid taking financial risk if the outcome is likely to be a gain or a loss of an equal amount of money. Studies in behavioral finance reveal that a loss produces twice as much emotional discomfort as the pleasure derived from a gain of the same amount. In other words, losing $1,000 feels as bad as gaining $2,000 feels good. Loss aversion refers to investors' tendency to avoid risk unless the assumed payoff will be a multiple of the potential loss.

Third on the list is **confirmation bias**. This is best explained as the tendency to seek information that reinforces one's pre-existing beliefs while ignoring contradictory information. When clients own individual stocks, it's not uncommon for them to remember only the good news and ignore the bad news about the stocks they own.

In fourth place is **familiarity/home bias**. We tend to be comfortable owning stocks in companies that we work for or whose products we use. For example, Costco employees have 38% of their 401(k) assets invested in Costco stock. A preference to invest in domestic stocks is a common manifestation of home bias.

Anchoring bias is next on the list. It's the tendency to focus on a specific reference point when making investment decisions. For example, investors often "anchor" their sell decision about a stock based on how its current price compares to its purchase price. If the price is higher, they are more likely to sell than if the price has declined. Anchoring bias often causes investors to hold on to a losing position; they are unwilling to sell and realize a paper loss. It's a mistake to believe that a decline in an asset's price isn't a loss until it's sold. If it lowers your net worth, it's a loss.

Overconfidence. This is the tendency to overestimate our own abilities. Wall Street firms exploit investor overconfidence by marketing products designed to appeal to our "above average" mindset. Overconfidence didn't show up in the top ten behavioral client biases noted by advisors. However, overconfidence was identified by many advisors as a behavioral bias that they see in themselves. In the survey, 65% of advisors responded that they "strongly agreed" or "somewhat agreed" that their own portfolio management skills can help their clients outperform the market. This isn't overconfidence, it's delusional. No financial advisor or stockbroker has the skill to consistently add value to your portfolio by finding securities that the rest of investors have mispriced. Attempts to do so are more likely to increase portfolio risk and decrease return. The report noted, "*Seemingly, many advisers overestimate their own portfolio management skills and would be better served by having a clear and disciplined investment process that helps prevent the consequences of overconfidence, including excessive trading or improper management of risk.*"

Individual investors are constantly being chided for their susceptibility to behavioral biases. But individual investors have several behavioral advantages over professional money managers.

You have the option of doing nothing for months at a time except to continue funding your retirement plan. You can review your portfolio on an annual basis and rebalance its allocation if necessary. You can make your investment decisions based on a long-term time horizon and your personal financial goals. Professional investors have no such luxury. They must react to each day's market news and every Trump tweet that might move stock prices in the short-term. They must absorb each day's market noise, a distraction that can lead to bad behavioral mistakes. They're under constant pressure to deliver benchmark beating performance over relatively short time horizons and are skating on thin ice if recent performance trails their benchmark. They can't be seen as doing less than their competitors, so they're always tempted to do more – and not leave well enough alone.

You don't need a market forecast. Professional investors are expected to have firm views on the near-term direction of capital markets and the global economy. There is little or no evidence that any of them have any capability in this area, but they can never say, "I don't know." or "The future is unknowable.". In the money management business if you want to get to the top, it's better to be overconfident and wrong than to admit that you don't know what lies ahead.

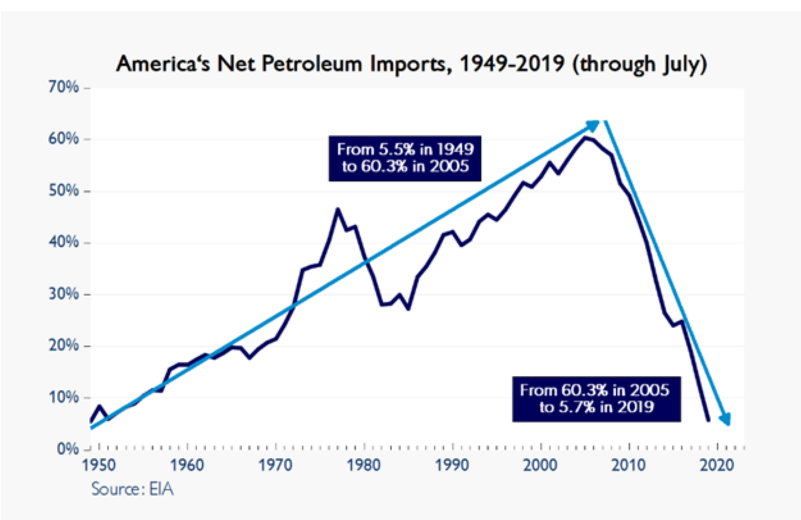
Your performance benchmark is the long-term rate of return that is needed to achieve your financial goals and it should be clearly stated in your financial plan. Professional money managers must match or outperform their stated benchmark and their competition year in and year out in order to remain employed. If you use index funds, you'll match the market's return. You don't need to be concerned with, or outperform, anybody else's returns.

Achieving superior returns is more difficult than most people can imagine. Fortunately, achieving adequate investment returns is easier than most people think. It's best accomplished by creating, and adhering to, a goals based financial plan that includes a recommended portfolio allocation that can be modified along the way as life events warrant. Financial journalism rarely identifies financial planning as the essential component of successful long-term investing; the emphasis is always on performance. It gives the impression that investing is primarily a timing and selection activity. The financial goals of most investors can be accompanied by capturing the long-term returns that the capital markets have historically yielded. This simple truth has escaped most investors.

Behavioral economics is fascinating but doesn't tell us how to mitigate the problems that it identifies. We'll never eliminate behavioral biases, but most of them can be avoided by being patient and disciplined and focusing on your long-term goals rather than the stock market's short-term performance.

In the News

The USA has more than doubled its crude output over the last decade. Much of the growth comes from the Permian Basin of West Texas and New Mexico. The USA's net petroleum imports in July of this year were at a 70-year low of only 5.7% of monthly demand, down from a peak of 60.3% in 2005. The drone strike on Saudi Arabian oil production facilities on Sept.14th caused a 14% spike in oil prices that disappeared by the end of the month. Among the factors pressuring prices are an increase in domestic inventories, a slowdown in global economic growth and the upcoming completion of pipelines to the Gulf of Mexico that will increase oil exports; making the USA a net exporter of oil. All this new oil production is the result of the innovative oil and gas production technique known as hydraulic fracturing, or "fracking". It enables drillers to free up previously inaccessible oil and natural gas from shale formations. U.S. shale oil production is now about 8 million barrels a day, or roughly 10% of global oil production. Fracking is a strategic U.S. asset, yet several Democratic presidential candidates have called for a ban on fracking. Politics is full of stupid ideas, but I'm hard-pressed to find one dumber than this one.



The investor gap is the performance cost of attempting to time the market instead of adopting a buy and hold strategy. Many investors are more active than prudence would dictate. Combine a limited understanding of financial concepts with the lack of a financial plan to help prevent behavioral mistakes and, voilà, the investor gap.

In its Mind the Gap 2019 update, Morningstar calculated that the average investor in stock and bond funds underperformed the performance of these funds by approximately 0.5% annually over the fourteen years ending in December 2018. Numerous studies of investor behavior reveal that the more you ponder your portfolio, the more you'll trade and the bigger your personal investor gap is likely to be. In summary Morningstar noted, "*To make the most of your mutual funds, you need a good plan and the willingness to stick with it amid all the trauma in the markets…A good plan and patience will serve you well.*" The large exodus of money from stock funds during last year's fourth quarter market decline will keep the investor gap alive and well in 2019 and ensures that investors will underperform the very funds that they owned last year at this time.

President Ford signed the Securities Acts Amendments of 1975 which eliminated fixed commissions on securities trades. This led to a proliferation of discount brokers, Charles Schwab being among the first. Earlier this month, E*TRADE, Charles Schwab and TD Ameritrade announced that they would eliminate commissions on all trades for stocks, exchange traded funds and options. This is the culmination of a multiyear trend of online brokerage firms cutting their trading fees in order to maintain market share. The strategy of giving away product to maintain market share didn't work in the airline business and the stock prices of all three companies declined sharply after the announcement. There has never been a better time to be an investor. You can create a globally diversified portfolio of index funds for free with annual expenses barely above zero. This is a big winner for investors paid for by the shareholders of discount brokerage firms.

This year, through the end of August, the S&P 500 Index was up 17.5% in total return. According to S&P, ten stocks returned at least 62% (led by a return of 94% by Chipotle), and ten stocks lost at least 37% (the worst performer being Dupont, with a loss of almost 58%), a top to bottom gap of 152%. This presented a golden opportunity for active fund managers to buy the winners and avoid the losers. Yet, the Vanguard S&P 500 Index fund, VFINX, has outperformed about two-thirds of actively managed large-cap domestic funds year-to-date through August.

American families need high quality, cost-effective financial advice. How to meet this need and grow your financial planning business is a common topic in trade publications for financial advisors. Recently, I came across an article about Marcos Tamayo, a 46-year-old solo practitioner who, in little more than a decade, grew his business to 900 clients and $172 million under management – a noteworthy achievement. Let's see how he did it.

Marcos started his business in Las Vegas in 2003 while working as a baggage handler for a domestic airline. He claims to have learned about investing by taking classes at work and reading books during work breaks. Apparently, he had plenty of time to study on the job because he named his business, Bored at Work Retirement Services. Marcos didn't get bogged down with the irritating details of setting up a financial advisory business. He didn't take the Series 65 exam that is required by most U.S. states for investment advisors. It covers subjects such as laws, regulations, ethics, retirement planning, portfolio management, and fiduciary responsibilities. He also failed to register his business with the Nevada State Securities Division or the SEC.

Marcos started managing the 401(k) accounts for a few friends at work and his business grew slowly by word-of-mouth. Business took off in 2015 after he posted a cropped screenshot of a client's 401(k) account statement worth nearly $1 million. He claimed it was his account and used it to tout his personal trading success and promised to use the same market timing strategy for his clients – for a $300 annual fee. Unknown to his clients, Marcos' 401(k) never exceeded $160,000. Once clients gave him online access to their 401(k) accounts, he made fund selections and market timing trades for them. His firm had no written code of ethics or written compliance policies or procedures and failed to keep a record of client correspondences and trades made in client accounts as required by securities regulations.

In August 2017, the Nevada State Securities Division learned that Tamayo was acting as an unlicensed investment advisor and required him to stop operating his business until properly licensed. Well, you can't keep good man down and in May 2018, Tamayo registered his firm with the SEC without mentioning his disciplinary history with the state of Nevada. Last month, the SEC issued a cease-and-desist order against Bored at Work Retirement Services for making untrue, false or misleading statements and advertisements as well as failing to make and keep required books and records. He has agreed to reimburse clients a total of $155,000 and pay a fine of $50,000.

Fake financial advisors are an ongoing problem in the financial advisory business – one that is rarely mentioned and of which the investing public remains unaware. Sadly, more than 900 people failed to do basic vetting on Tamayo's background or qualifications before giving him trading authority in their 401(k)s. The first place to check on a financial advisor or broker is on the Brokercheck website. The site has been criticized for having incomplete or out-of-date information. But if a financial advisor or broker isn't listed there, it's a red flag and it's time to start asking questions.