BlueTrust

Weathering the *Behavioral Seasons of Investing*

You have most likely heard the adage, "Keep your expectations low, and you'll never be disappointed." No matter how logical this advice may seem, managing our expectations can be challenging. We are all driven by beliefs and emotions that influence our opinions of how things should be.

Investing is no exception. All investors enter the market with certain expectations—usually to make money. Of course, how much money and at what cost can vary dramatically from investor to investor. If these expectations are unrealistic, investors are more likely to experience disappointment and make untimely investment decisions.

All investment strategies have alternating periods of comfort and discomfort, which we call "behavioral seasons." These seasons are generally external market environments that elicit emotion from investors. Some seasons are favorable to investors, while some are not. Typically, seasons of Discontentment bookend a season of Contentment.

Fortunately, a season doesn't last forever. Instead, it unpredictably transitions from one to the next and back. For investors unaware of the nature of these seasons, abandoning their investment plans at the worst possible times during periods of discomfort can be tempting. That decision ultimately could cause them to fall short of their financial goals.

We believe investors who understand the nature of behavioral seasons are more likely to weather them and meet their long-term goals. Understanding and internalizing behavioral seasons requires a couple of critical steps. First, investors must clarify their definition of investment success. Second, they must prioritize the risk trade-offs they will encounter with each behavioral season beforehand.

Defining Success

An investment strategy's effectiveness is determined by how the investor defines success. In other words, what do they expect from their portfolio? What is their goal? Broadly, investors have three primary objectives: 1) meet future cash flow needs, 2) keep up with popular market indexes, and 3) limit volatility. It is no coincidence that these three investor goals also define the nature of behavioral seasons. We will look at these more closely in the next section.

> "Amid uncertainty, the way investors define success may change."

Many investors define success as meeting their future cash flow needs. However, the future is uncertain, so they may not see clear results for some time. Studies show that in times of uncertainty, people tend to shift from relying on objective analysis to trusting what others are doing.

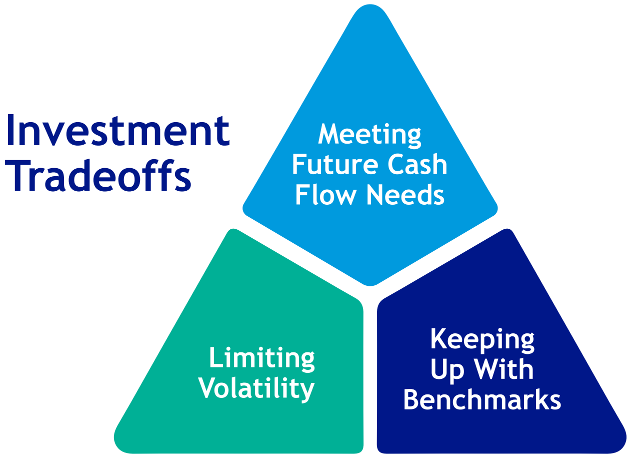
For example, suppose someone is walking down a crowded street, and suddenly, everyone begins running in the opposite direction. In that case, the person may follow the crowd without stopping to complete their own analysis of the situation. Perhaps the crowd knows something they don't. Sometimes, a portfolio designed to meet future cash flow needs can perform very differently than the market. Does the market know something that investors don't, or is the market performing irrationally? Amid uncertainty, the way investors define success may change.

This reaction is why defining success is so important at the outset. An uncertain future means that no one can control outcomes, only the processes they employ in an effort to achieve their desired outcomes. Therefore, investors must seek to be satisfied with their investment *process*—which is different than being content with investment *outcomes*. Behavioral seasons will test investors who adopt a strategy inconsistent with their core beliefs. In our experience, the likelihood of these investors abandoning their investment approach at the worst time is very high and likely more damaging than remaining invested in the perceived "wrong" strategy.

Prioritizing Risk Trade-Offs

As much as we would like to achieve all three investment goals all the time, the perfect investment strategy doesn't exist. To find success in one area, investors must accept the possibility of being less successful in another. Therefore, they must make some tough decisions to prioritize their investment objectives. Without defining success beforehand, investors' emotions can tempt them to switch strategies rather than follow a rational, thought-out financial plan.

Let's take a closer look at the three common investment goals mentioned previously and how they relate to fears that form behavioral seasons.



Keeping Up with Benchmarks

The media tends to focus on the performance of a few U.S.-based benchmarks when reporting market-related news. Many investors interpret these results as how their peers' investments are performing and become frustrated if their investments miss the mark. Therefore, investors in the U.S. may feel better if their portfolios match the performance of the S&P 500. This sentiment is called 'home country bias' and exists in every country. No matter where you go globally, investors tend to feel more comfortable with a portfolio that reflects a very high allocation to their domestic financial markets. The downside of this approach is that the performance of popular benchmarks may not reflect every investor's future cash flow needs. In addition, equity markets tend to be volatile and experience periods of low or negative returns.

Limiting Volatility

While nearly all investors are loss-averse, a generally accepted principle of investing is that most investments can potentially lose money. The longer an investment's duration (or time horizon), the greater the potential for short-term price swings, which can be unnerving for investors.

In the global financial crisis (GFC), stocks lost more than half their value between 2007 and early 2009. In March 2009, investors were still very concerned about a further 20% or 30% drop in stocks due to deteriorating financial conditions. The potential pain of another decline required significantly more conviction to stay invested than the first 50% drop. The capacity of investors to handle losses tends to decrease with each percentage point drop in the value of their investments.

As it turns out, U.S. large-cap stocks more than doubled by 2019 from the highs in 2007 before the GFC and more than tripled from the lows of 2009. However, there were no guarantees that investors who had the patience to ride out the volatility would be rewarded. Although investing in a portfolio that minimizes volatility is certainly more comfortable, investors must be willing to miss out on potential periods of significant market appreciation to maintain their comfort levels. As a result, the probability of meeting future cash flow needs may also be reduced.

Meeting Future Cash Flow Needs

We believe the most profound trade-off is the decreased probability that investors will meet their future financial goals. When investors measure success by this metric, domestic benchmark performance and periods of short-term losses are less relevant. However, investors still may experience the discomfort those periods can bring.

Portfolio Goal	Expect	Do Not Expect	Point of Discomfort	Success Gauge
Keeping Up With Benchmarks	Performance similar to peers and/or major benchmarks	To avoid short-term losses or have the highest probability of meeting future cash flow goals	Periods of low or negative market returns	Returns that are similar to major benchmarks
Limiting Volatility	The portfolio to protect against dramatic losses over the short term	Performance similar to major benchmarks and/or peers over the long term or the highest probability of meeting future cash flow goals	Strong performance of major benchmarks	Low volatility
Meeting Future Cash Flow Needs	A diversified portfolio constructed specifically to align with a financial plan	Performance similar to major benchmarks and/or peers or protection against short-term losses (for long-term portfolios)	Strong performance of major benchmarks or periods of short-term volatility	Increased exposure to better valuations and higher economic growth and progress toward meeting future cash flow goals

Recognizing Behavioral Seasons

Ideally, all investors would always feel content and never worry about investment performance. However, emotional and practical setbacks are inevitable when it comes to investing. These obstacles are natural but can be exacerbated when expectations are not set or met.

As human beings and investors, we naturally tend to let emotion enter our decision-making. One of the most dominant emotions that affects our ability to make sound investment decisions is fear. Every investment goal has an associated fear of not being achieved. Investors are more likely to experience the fear of loss (FOL) when their portfolios don't effectively limit downside volatility. Investors experience a fear of missing out (FOMO) when their diversified portfolios lag behind broad market indices. Both FOL and FOMO cause investors to experience the fear of failure (FOF) as they consider their futures and financial plans.

Portfolio Goal	Potential Fears (Seasons)
Keeping Up With Benchmarks	Fear of Missing Out (FOMO)
Limiting Volatility	Fear of Loss (FOL)
Meeting Future Cash Flow Needs	Fear of Failure (FOF)

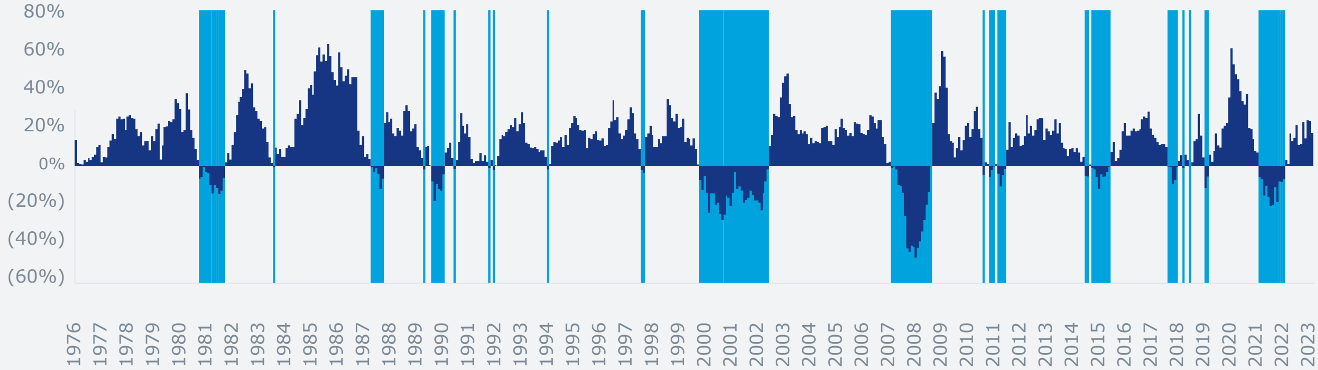
These fears are rational and represent concerns about whether an investor's portfolio is tracking toward longer-term goals. FOF is at the heart of investor concerns and is channeled via FOL and FOMO. FOF is a long-term concern, and FOL and FOMO are rooted in short-term observations. As investors attempt to evaluate how they're doing at progressing toward their long-term goals, they look for short-term reassurance to gain confidence. Typically, investor confidence is found in portfolio performance. When investors aren't content with their investment strategy, they're typically experiencing FOL or FOMO. These emotions occur frequently enough and are predictable enough to categorize them as behavioral seasons.

Fear of Loss (FOL)

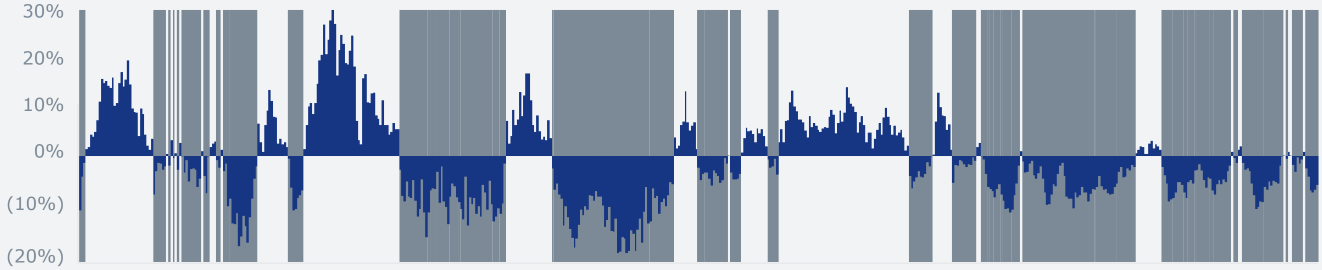
Behavioral economists have found that for most people, the pain felt from losing even a nominal amount of money is much stronger than the joy felt by gaining the same amount. Consequently, investors tend to fear loss and avoid it at all costs. FOL is one explanation of why so many investors flee to cash and other relatively safe investments during market downturns.

FOL seasons sometimes occur at different times for different people. In general, for an investor in a diversified equity portfolio, an example of a FOL season is when the MSCI ACWI generates a below-zero return on a rolling one-year basis, as illustrated in the graph on the next page.

Fear of Loss (FOL)



Fear of Missing Out (FOMO)



Source: FactSet. Fear of Loss (FOL) describes 12-month periods when MSCI ACWI had negative returns. Fear of Missing Out (FOMO) describes 12-month periods when MSCI ACWI underperformed the S&P 500.

Fear of Missing Out (FOMO)

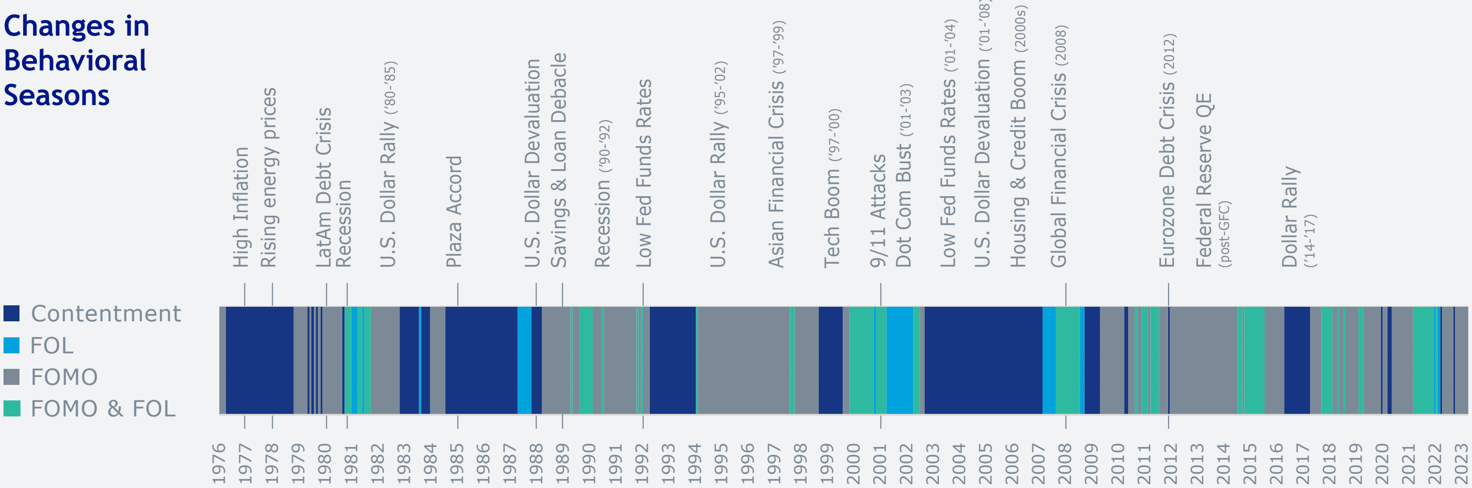
Investors experience FOMO when they believe their portfolios are underperforming their peers' portfolios. Since most individual investors don't know how their immediate counterparts are performing, they often use recognized broad market indexes such as the Dow Jones Industrial Average or S&P 500 Index as proxies for peer performance. As a result, many investors feel discomfort when their portfolios fail to keep pace with these benchmarks.

Consider the same investor who holds a diversified global stock portfolio. For this investor, a basic example of a FOMO season is when their portfolio underperforms the S&P 500. These periods are illustrated in the chart above.

A key takeaway from these charts is how often FOL and FOMO seasons can occur. Importantly, these seasons correspond nicely with the performance trade-offs described previously. Depending on a portfolio's primary investment strategy, an investor is likely to feel FOL, FOMO, or both many times during their investment horizon.

Continuing the same theme, the chart below illuminates the many changes in behavioral seasons between December 1976 and December 2023. During this time horizon, the average behavioral season on a rolling year-over-year basis lasted only seven months.

Changes in Behavioral Seasons



Source: FactSet. Content describes 12-month periods when MSCI ACWI (a global equity index) had positive returns and outperformed the S&P 500 Fear of Loss (FOL) describes 12-month periods when MSCI ACWI had negative returns. Fear of Missing Out (FOMO) describes 12-month periods when MSCI ACWI underperformed the S&P 500.

What does all this mean? As shown in the table below, **investors experience discomfort from fears about 65% of the time, irrespective of their chosen investment strategy.** Based on historical data, since 1976, the average investor only feels content about 35% of the time; FOMO 43% of the time; FOL 6% of the time; and both FOMO and FOL 16% of the time. Given these statistics, investors should anticipate feeling uncomfortable most of the time. Yet, most investors still expect to feel content more often than not, which explains why investor expectations are often off the mark.

Potential Fears (Seasons)	Occurrence Between 1976-2023
Fear of Missing Out (FOMO)	43%
Fear of Loss (FOL)	6%
Fear of Loss (FOL) and Fear of Missing Out (FOMO) simultaneously	16%
Discontentment	65%
Contentment	35%

Setting Reasonable Expectations

The decade-plus since the GFC has been challenging for most diversified investors, given the strong performance of U.S. stocks relative to nearly all other geographies and asset classes. Investors spent almost 90% of the time in some combination of a FOMO and FOL season. That reality means that U.S. investors experienced the Contentment season less than 15% of the time, much lower than the average 39%. The Contentment season hadn't been that elusive since the 1990s, which coincided with the tech bubble when FOMO was present about 70% of the time. Eventually, the seasons changed, and the markets rewarded patient investors.

Unfortunately, tough times are inevitable, even when market conditions are seemingly favorable. The good news is that it is possible for investors to still meet their financial goals despite feeling uncomfortable most of the time. Rather than trying to avoid these difficult periods, in our experience, it's better to 1) establish a financial plan, 2) understand that seasons of doubt will challenge your resolve to stick to that plan, and 3) set expectations accordingly. We believe that managing expectations by prioritizing investment goals and understanding the associated trade-offs helps investors weather all behavioral seasons and stay the course. This distinction can significantly impact investment success over the long term.

Appendix

Behavioral Season Characteristics

To explore these seasons in greater detail, the table below illustrates some of the historical characteristics of behavioral seasons in the same period (December 1976 to December 2019). The median period spent in each season is short—between 2.5 and 5 months (based on a year-over-year measurement)—so seasons change frequently. However, they have the potential to last for very long periods. The Contentment season has lasted as long as 54 months and FOMO for up to 42 months. Also, we can see that the FOL seasons tend to be shorter than the FOMO and Contentment seasons.

It is also worth noting that the average absolute return in a FOMO season is 15%, a high return rate. However, this result is overshadowed by the fact that the diversified portfolio lags the U.S. benchmark in these seasons, making many U.S. investors less than satisfied with such exceptional returns. During FOMO seasons, it is normal for a diversified portfolio to under preform U.S. benchmarks by 7.2% on average. The largest relative difference was 18.3% in 1997 during the tech bubble.

How Seasons Evolve and Resolve

Our study also looks into how seasons have transitioned historically—where seasons come from and to. Historically, Contentment seasons have moved into a FOMO or FOL season, but this is not the trend with the other seasons. As seen in our analysis, FOL has never transitioned to FOMO, FOMO has never moved directly into a FOL season, and the combination of FOL and FOMO seasons has not led to Contentment.

Contentment seasons have transitioned to FOMO periods 71% of the time. FOMO seasons have always transitioned into either a Contentment season or a combination FOL and FOMO seasons. The one constant is that the seasons continue to cycle from one to another.

Historical Characteristics of Behavioral Seasons

	Amount of Time	Median Periods (Number of Months of YOY Periods)	Longest Periods (Number of Months of YOY Periods)	Average Absolute Return (YOY)	Average Relative Return (YOY)	Worst Absolute Return (YOY)	Worst Relative Return (YOY)
Contentment	39%	5.0	54	22.0%	7.6%	-	-
FOL	6%	2.5	12	-10.2%	3.8%	24.9%	-
FOMO	41%	3.5	42	15.0%	-7.2%	-	-18.3%
FOL & FOMO	14%	3.0	11	-13.1%	-5.3%	-47.2%	-12.8%

Source: FactSet. Absolute return is actual total return of MSCI ACWI. Relative return represents YOY differences between MSCI ACWI and S&P 500.

...To Next Season

From Current Season...	Contentment	FOL	FOMO	FOL & FOMO
Contentment	N/A	18%	71%	12%
FOL	38%	N/A	0%	63%
FOMO	48%	0%	N/A	52%
FOL & FOMO	0%	23%	77%	N/A