RonaldBlueTrust®

Wisdom for Wealth. *For Life.*®

Weathering the Behavioral Seasons of Investing

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Introduction

We've all heard many variations of the adage, "Keep your expectations low, and you'll never be disappointed," throughout our lives. Logical as this advice may seem, it's not always easy for us to manage expectations. We are all driven by beliefs and emotions that influence our opinions of how things should be.

Naturally, 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. When 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. We refer to these periods as "behavioral seasons." These are general external market environments that tend to elicit emotion within investors. Some seasons are favorable to investors, but some are not. Typically, seasons of contentment are bookended by seasons of discontentment or discomfort.

A season doesn't last forever. Instead, it transitions from one to the next and back again in unpredictable ways. For investors who are unaware of the nature of these seasons, it can be all too tempting to abandon their investment plans at the worst possible times during periods of discomfort—a decision that 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 these seasons and meet their long-term goals. Understanding and internalizing behavioral seasons requires a couple of critical steps. First, they must clarify their definition of investment success. Second, they must prioritize beforehand the risk trade-offs they will encounter with each behavioral season.

Behavioral Seasons and Investing

Defining Success

The effectiveness of any investment strategy is determined by how investors define success. In other words, what do they expect from their portfolio? What is their goal? Broadly, investor goals tend to boil down to three objectives:

1) Meeting future cash flow needs

2) Not deviating too far from popular market indexes

3) Not experiencing drawdowns along the way (or limiting volatility)

It is no coincidence that these three investor goals also define the nature of behavioral seasons (more on this in the next section).

Many investors would say that meeting their future cash flow needs is how they would define success. However, the future is uncertain, so clear results can be delayed for some time. Studies show that in times of uncertainty, people tend to shift from relying on objective analysis to relying on what others are doing. For example, if someone is walking down a crowded street and suddenly everyone begins running in the opposite direction, they may not stop to do their own analysis of why everyone is running. Perhaps the crowd knows something they don't. There are times where a portfolio based on meeting future cash flow needs can perform very differently than the market. Does the market know something that investors don't or is the market being irrational? In the midst of uncertainty, the way investors define success may change.

This 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 outcomes. Therefore, investors must seek to be satisfied with their investment process—which is different than being satisfied with investment outcomes. Someone who adopts an investment strategy that is not consistent with his/her core beliefs will be tested in and throughout the various behavioral seasons. In our experience, the likelihood of this investor abandoning his/her investment approach at the worst time is very high and likely to be more damaging than remaining invested in the perceived "wrong" strategy.

Prioritizing Risk Trade-Offs

As much as we would like to experience all three investment goals all the time, the perfect investment strategy doesn't exist. To be successful in one area, investors must accept the possibility of being less successful in another. Therefore, some tough decisions must be made to prioritize investment objectives. Without defining success beforehand, investors are often tempted to switch strategies based on emotion rather than a rational 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.

1. Keeping Up with Benchmarks

The media tends to focus on the performance of a few U.S.-based benchmarks when reporting market-related news. There's a good reason for this. Many investors associate these results with how their peers are performing and become frustrated when their investments miss the mark. Investors in the U.S. may feel better if their portfolios match the performance of the S&P 500, for example. This is called 'home country bias' and it 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 own domestic financial markets. The downside is that the performance of popular benchmarks may not be relevant to every investor's future cash flow needs. In addition, equity markets tend to be volatile and experience periods of low or negative returns.

2. Limiting Volatility

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

In the financial crisis, 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 in stocks required a lot 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 value of their investments.

As it turns out, U.S. large-cap stocks more than doubled by 2019 from the highs in 2007 prior to the financial crisis 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 in such a fashion. Although it is certainly more comfortable to invest in a portfolio that minimizes volatility, investors must be willing to miss out on potential periods of major market appreciation to maintain their comfort levels. As a result, the probability of meeting future cash flow needs may also be reduced.

3. Meeting Future Cash Flow Needs

We believe the most profound trade-off associated with keeping up with market benchmarks or limiting portfolio volatility is the decreased probability that investors will meet their future financial goals. When success is measured by the ability to meet future cash flow needs, domestic benchmark performance and periods of short-term losses are less relevant. Still, investors may experience periods of short-term volatility and under-performance relative to major market benchmarks when their investment strategies are aimed towards meeting their specific financial needs.

The table on the next page summarizes these three common investment goals and the associated trade-offs, or points of discomfort.

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. Progress towards meeting future cash flow goals.

Recognizing Behavioral Seasons

Ideally, all investors would always feel content and never worry about investment performance. However, when it comes to investing, emotional and practical setbacks are inevitable. These setbacks are natural but can be exacerbated when expectations have not been set or are not being 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. For every investment goal there's an associated fear of not achieving that goal. 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 ponder their futures and their financial plans.

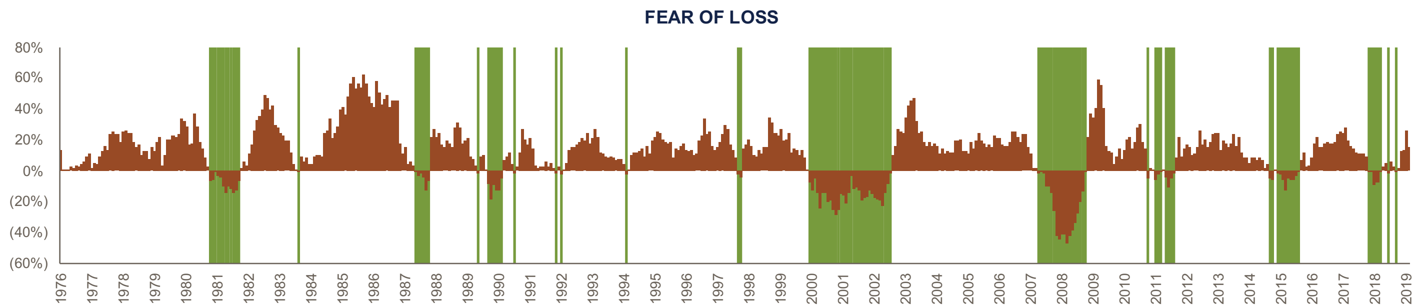
PORTFOLIO GOAL	POTENTIAL FEARS (SEASONS)
Keeping Up with Benchmarks	Fear of Missing Out (FOMO)
Limiting Volatility	Fear of Loss (FOL)
Meeting Future Cash Flow Needs	Fear of Failure (FOF)

These fears are rational and represent concerns as to whether the portfolio is tracking toward longer-term goals. FOF is at the heart of investor concerns and it 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 clues they can rely on 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 for why so many investors flee to cash and other relatively safe investments during market downturns.

FOL seasons don't always occur at the same time for all investors (although they can). In general, for an investor in a diversified equity portfolio an example of an FOL season is when their portfolio generates a below-zero return, as illustrated in the graph below by the green bars.

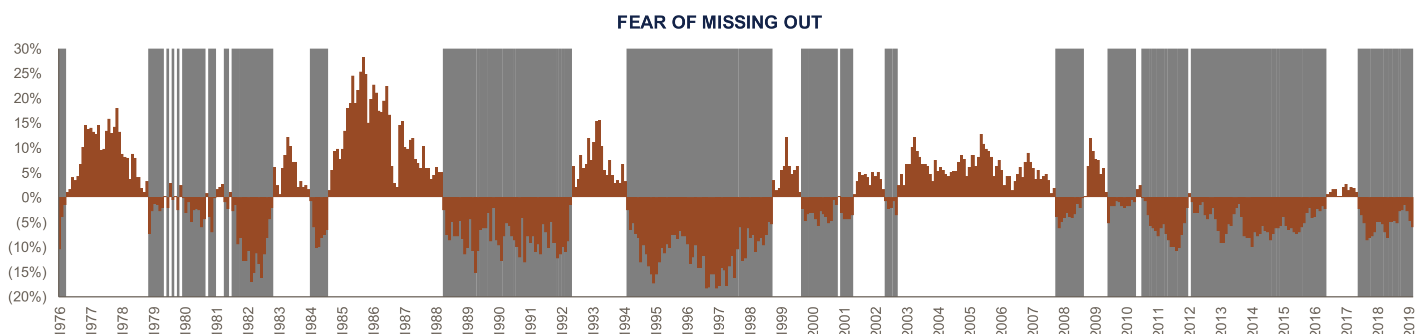


Source: FactSet. Fear of Loss (FOL) describes 12-month periods when MSCI ACWI had negative returns.

Fear of Missing Out (FOMO)

Investors experience FOMO when they believe they're underperforming their peers. Since most individual investors don't know how their immediate peers 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.

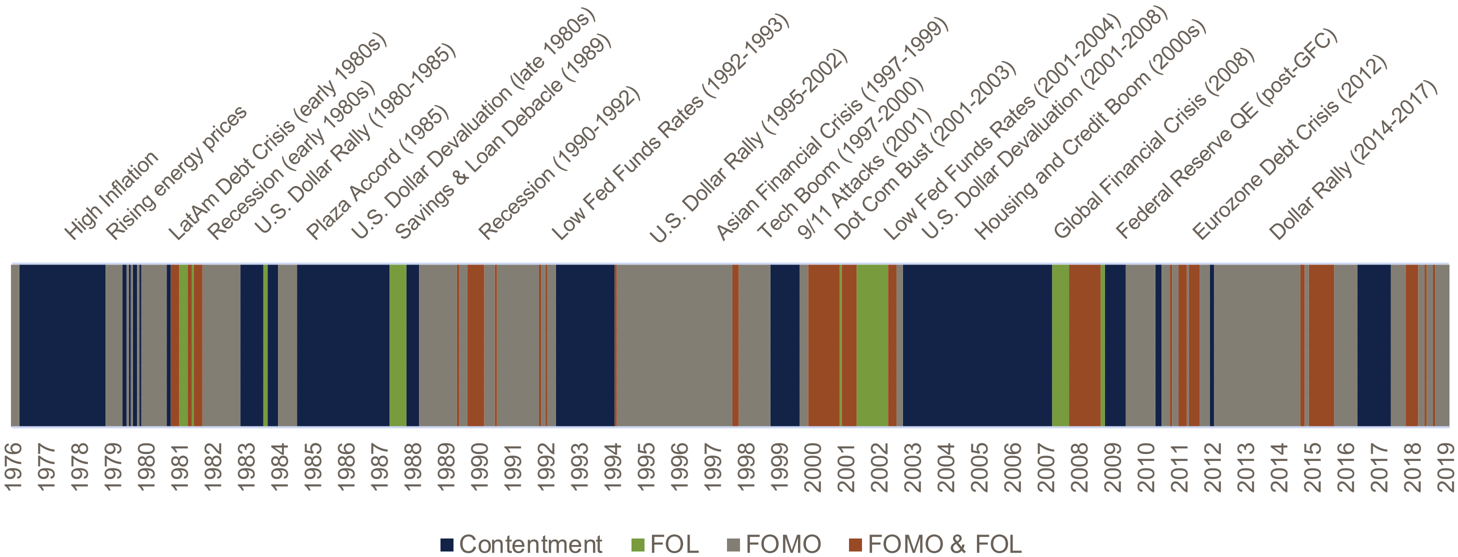
Consider the same investor, who holds a diversified global stock portfolio. For this investor, a basic example of a FOMO season is when their portfolio underperforms the S&P 500, a broad market index that the average investor recognizes and follows. These periods, shown by the gray bars, are illustrated in the chart below.



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

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 over the course of their investment horizon as they experience these trade-offs.

Continuing the same example, the chart below illuminates the many changes in behavioral seasons between December 1976 and December 2019. During this time horizon, the average behavioral season on a rolling year-over-year basis lasted only seven months.



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? Shown in the table below, **investors experience discomfort from fears about 61% of the time irrespective of what investment strategy they choose.** Based on historical data, since 1976, the average investor only feels content about 39% of the time; FOMO 41% of the time; FOL 6% of the time; and both FOMO and FOL 14% of the time. Given this data, investors should expect to feel uncomfortable a majority 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 1976–2019
Fear of Missing Out (FOMO)	**41%**
Fear of Loss (FOL)	**6%**
Fear of Loss (FOL) and Fear of Missing Out (FOMO) Occurring Simultaneously	**14%**
Discontentment	**61%**
Contentment	**39%**

Setting Reasonable Expectations

The decade or so following the financial crisis 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 have spent 80% of the time in some combination of a FOMO and/or FOL season. That means that U.S. investors have experienced the Contentment season less than 20% of the time, much lower than the average 39%. This has really tested the investing mettle of the diversified U.S. investor. The last time the Contentment season was that low was during the 1990s. This coincided with the tech bubble and FOMO was present about 70% of the time. Suffice it to say that eventually the seasons changed, and patient investors were rewarded.

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—a distinction that 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 time 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 of time. The Contentment season has lasted as long as 54 months and FOMO has lasted as long as 42 months. Also, we can see that FOL seasons tend to be shorter than FOMO and Contentment seasons.

HISTORICAL CHARACTERISTICS OF BEHAVIORAL SEASONS

	% Of TIME	MEDIAN PERIODS (# OF MONTHS OF YOY PERIODS)	LONGEST PERIODS (# 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.

It is also worth noting that the average absolute return in a FOMO season is high at 15%. However, this return is overshadowed by the fact that the diversified portfolio lags the U.S. benchmark in these seasons, leading many U.S. investors to be less than satisfied with such exceptional returns. It is normal during FOMO seasons for a diversified portfolio to lag U.S. benchmarks by 7.2% on average. The worst 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—that is to say, where seasons go from and to. Historically, Contentment seasons have potentially moved into any of the other FOMO or FOL seasons, but this is not the case with the other seasons. As seen in our study, FOL has never transitioned to FOMO; FOMO has never moved directly into a FOL season; the combination FOL and FOMO season has not resolved to Contentment.

FROM CURRENT SEASON...	...TO NEXT SEASON: CONTENTMENT	FOL	FOMO	FOL & FOMO
CONTENTMENT	NA	18%	71%	12%
FOL	38%	NA	0%	63%
FOMO	48%	0%	NA	52%
FOL & FOMO	0%	23%	77%	NA

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