Tigers, Your Brain, and Your Portfolio

Experience tells us that the best time to reflect upon our emotional responses to market downturns is when markets happen to be in a bit of an up-cycle. We are certainly not forecasting market gloom and doom; we simply know that the timing is prudent for a behavioral finance "lifeboat drill." All of us can agree that emotional preparations tend to be more rational when the proverbial ship is not taking on water.

Despite positive year-to-date returns in nearly every asset class, investors have plenty of choices as to what to worry about these days: Congressional stalemates, troubles in the euro zone, the economy, housing, the national debt, Obamacare, etc. The list goes on and on, and it can seem like we live in especially worrying times. The fact is we do not, but nonetheless, we are always going to worry, since our brains are wired to worry about things that we think might harm us. It's a survival mechanism that protects us from danger. Fear narrows our focus. The onset of fear allows us to ignore our surroundings, eliminate distractions, and concentrate on our immediate survival options.

Picture yourself strolling along in the park and then suddenly looking up and seeing a large and hungry-looking tiger 10 feet from where you stand. Your fear conditioning will simultaneously allow you to stand absolutely still, increase your heartbeat, take quick breaths to build oxygen levels in your blood, release stress hormones, and trigger an adrenaline rush faster than you can say "nice kitty." You certainly won't be thinking about what's for dinner tonight or if your 401(k) is well-positioned for your retirement goals.

Fear allows us to ignore any long-term consequences; and to act without delay using an emotional, not an empirical, response to danger. That's great for avoiding tigers, but not great as an investment strategy. From a scientific standpoint, those fear-based responses are handled by a part of our brain called the amygdala, which is responsible for the storage of emotional memories. Some of the strongest emotional imprinting in the brain is caused by past trauma, such as burning your hand on a hot stove or dropping a brick on your toe. While that's great for avoiding bodily harm, the problem is that the same fear conditioning related to "losing your money in the stock market" is stored in the part of the brain that makes us afraid of tigers. Fear can cause us to make irrational short-term decisions that harm our portfolios in the long-term.

Unfortunately, that fear comes with a price. For concept demonstration, imagine for a moment that it's October 2008 and you're sitting on a portfolio of $2 million invested broadly in the US equity market. You open the paper to find that Lehman Brothers and Bear Stearns have just collapsed, and every financial pundit on the planet is predicting further financial Armageddon for decades.

Alarm bells are going off in your head, as your fear conditioning is telling you to sell your portfolio and stock up on flashlight batteries, shotgun shells, and canned goods to wait out the coming collapse of capitalism.

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So, it turns out that the price of that fear is very, very expensive. In rough figures, if assets were left invested in the US market, that $2 million portfolio valued in the most desperate moments of 2008 would be worth about $3.6 million today. Even though historical research shows that markets recover on average about 24 months after each decline, investors still tend to liquidate their portfolios in response to fear of the markets dropping. They do so typically after the market has already significantly declined, exacerbating the magnitude of their loss.

Ignoring your fear conditioning is not easy, especially when other investors are panicking. Try to remember that when markets decline, others are seeing a hungry tiger in their walking path. As an educated investor, you will simply be seeing a normal and expected part of being a long-term investor. Perhaps you might be kind enough to remind those in the throes of misguided panic that fear is not a particularly good investment strategy.

That's Clearly Ridiculous

Imagine that last week you purchased a brand-new Toyota Camry for your daughter (or another deserving family member). Your intent was to find a sensible, long-term vehicle for her needs. You deliberated, and eventually chose a silver-colored car off the lot; and treated your daughter a bit by selecting the leather option, V-6, and navigation. In the end, you were a bit proud of yourself that you managed to haggle a little and get the price down to an even **$30,000**.

Further imagine that your mouthy neighbor pulls up in an identical car, except that his is black. He steps out and proudly tells you that he too stepped up for the leather, V-6, and navigation—and that he was able to bargain a good deal and drive it off the lot for only **$270,000**.

Sounds ridiculous, right? Clearly, he must be joking since no informed consumer would pay nine times the going rate for an identical product— that's sheer lunacy. Sadly, it happens every day in the financial services industry—to bright, hardworking investors who run busy lives and who trusted their "advisor" to act in their best interests. They had no idea that the mutual fund, managed futures account, annuity, wrap account, closed-end fund, non-traded REIT, or other financial product purchased with their hard-earned dollars has expenses shockingly in excess of nearly identical alternatives.

Why is it so hard for the financial services industry to require standardized and full disclosure of fees paid by investors? Unmistakably, there is some level of immorality involved in obfuscating compensation inside of expense ratios, soft-dollar arrangements, custodial fees, sub-account agency transfer fees, bid-ask spreads, trading commissions, mortality and expense charges, and surrender charges—just to name a few.

The largest firms in the industry really should recognize that investors expect to pay a fee—but they do not expect it to be hidden. Could you imagine if your physician wrote you a few prescriptions and told you not to worry about paying for her services since the drug companies would take care of it on your behalf? That doesn't exactly build trust, does it?

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It is a sad state of affairs that it is actually a differentiator for us that we patiently and transparently explain in plain English the fees our clients pay and to whom. Furthermore, by educating our clients about the way large banks and brokerage firms make profits, we are often able to show that their former advisors were not disclosing all the ways their firms were profiting. Our experience tells us that prospective clients are often irate with their former advisory firms when we lay out the fees they have been paying in the past without their knowledge.

When firms are evasive or shifty about their clients' fees, it makes one think they are hiding something—and that perhaps they are less-than-capable advisors. Clients deserve straight answers and disclosure. Why is that so hard for the industry to get right?

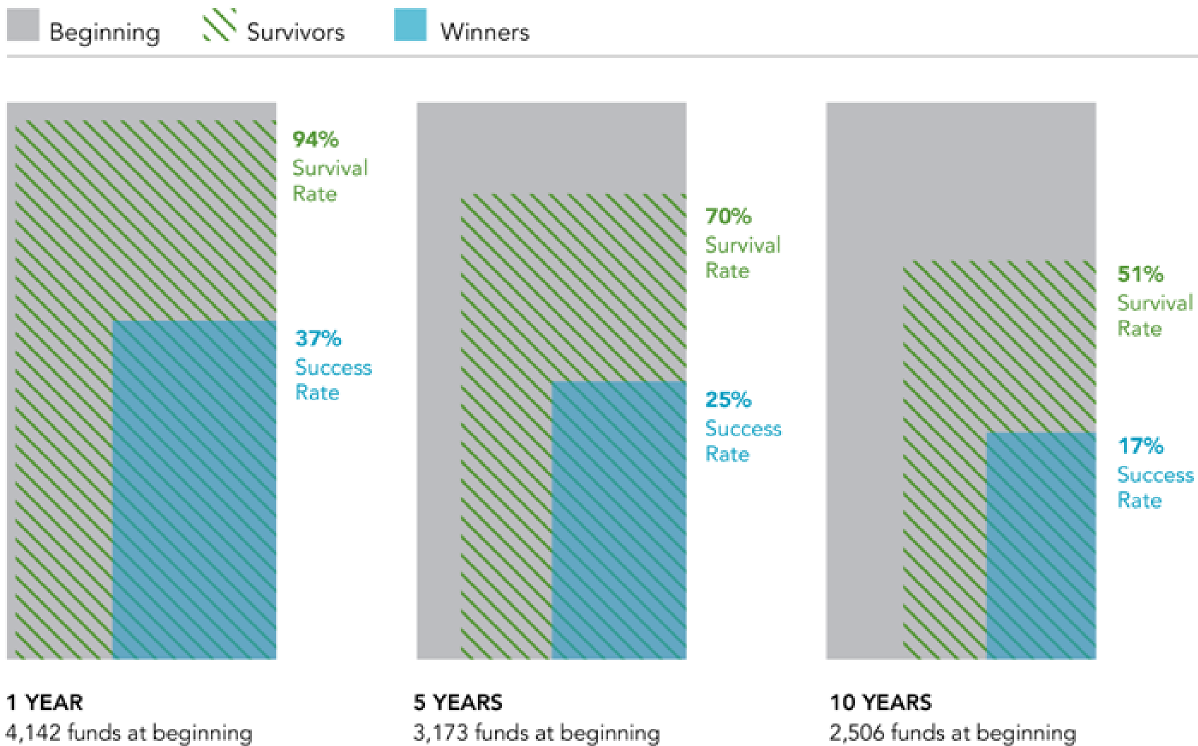
The Case of the Disappearing Mutual Funds

Many investors focus on trying to find mutual funds that beat the market—a fool's errand, to be sure. How about just trying to find mutual funds that are going to be in existence 10 years from now? The rising fund count and annual growth in assets mask the fact that many funds disappear each year, almost exclusively as a result of poor investment performance. In the chart below, the large gray boxes represent the number of US-domiciled equity funds in operation during the past one, five, and 10 years. These funds compose the beginning universe of each period.

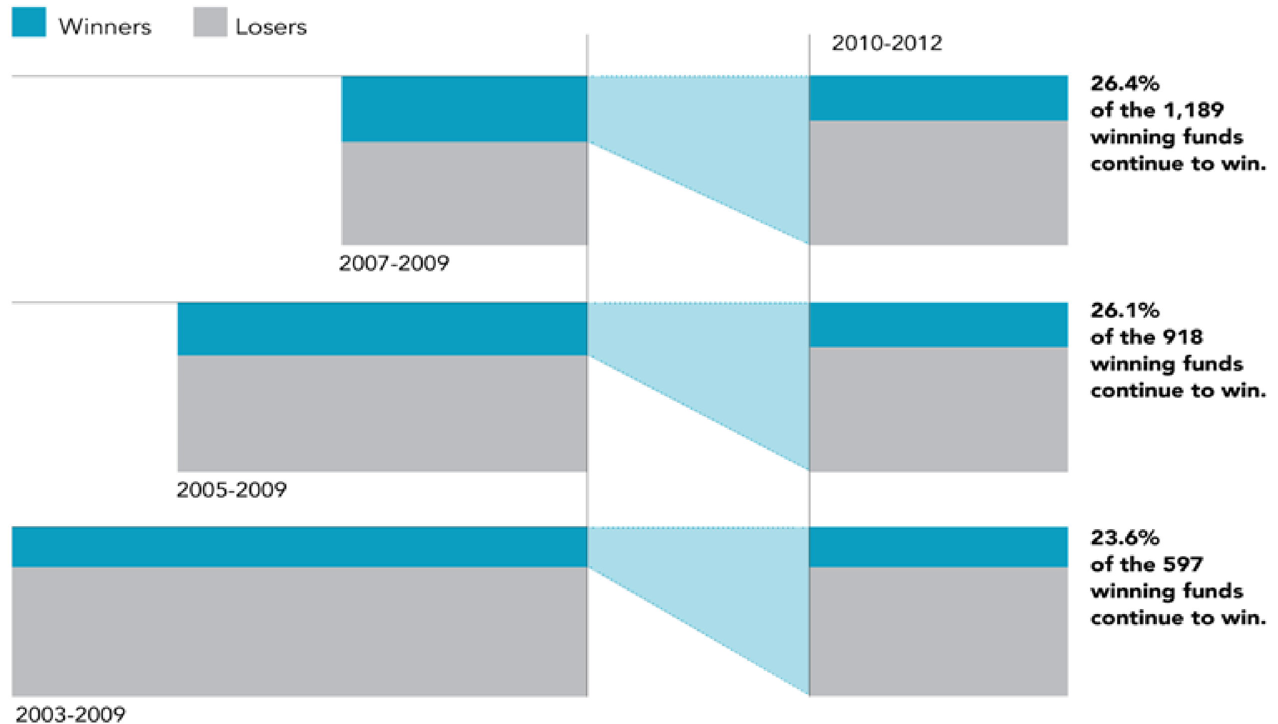
For example, an investor trying to select a mutual fund five years ago, at the start of 2008, could have chosen from more than 3,000 equity funds.

How many of these funds were still alive at the end of 2012? The striped areas show the proportion of the beginning funds that survived. During the one-year period, 6% of equity funds closed up shop. Over time, survival rates dropped sharply. In equities, the five- and 10-year survival rates were just 70% and 51%, respectively.

But investors want to do more than just pick a fund that survives. Most people are on a hunt for funds that will outperform a benchmark. What were the chances of picking a winning fund?



Data provided by the CRSP Mutual Fund Database. Source: CRSP data provided by the Center for Research in Security Prices, University of Chicago.



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The blue shaded areas show the proportion of equity funds that outperformed their respective benchmarks. In 2012, 37% of equity funds survived and outperformed their benchmark for the one-year period. The numbers are even worse for longer horizons. About one in four funds survived to provide benchmark-beating performance over the five years through 2012. Over 10 years, the figure dropped to one in six funds.

The competitive landscape makes the search for future winners a formidable challenge. Confronted with so many fund choices—and lacking an investment philosophy to guide their search—some investors resort to picking funds that have strong track records, reasoning that past outperformers will continue to outpace their benchmarks.

Does this assumption pay off? **In a word: no**. The research offers strong evidence to the contrary.

The chart shown illustrates the lack of persistence in outperformance. Three-, five-, and seven-year equity mutual fund track records are evaluated as of December 2009. Funds that beat their respective benchmarks are re-evaluated in the subsequent three-year period ending December 2012.

Only about a quarter of the equity funds with past outperformance during the initial three-year period (2007–2009) continued to beat their benchmarks in the subsequent three-year period (2010–2012). Longer track records do little to help investors identify future outperforming funds. The results for funds with good five- and seven-year track records were similar—only about a quarter beat their benchmarks in the subsequent period. Amateurs spend their time trying to pick "winners" and rationalize market forecasts. Experts build low-cost, globally diverse, risk-controlled portfolios using reliable institutional-style investment vehicles that will not disappear over time.

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