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How I Learned to Stop Worrying and Love Capital Markets

BY BRAD KNAPP, CFA, CAIA

In Stanley Kubrick's classic 1964 film "Dr. Strangelove," U.S. Air Force Brigadier General Jack Ripper fully detaches from reality and lets irrational emotion drive his thoughts and actions. Fear overwhelms facts, causing him to set into motion a nuclear military response that could end civilization.

Unfortunately, irrational beliefs and actions are not unique to General Ripper. Some of these tendencies, luckily on a scale nowhere near full-out nuclear holocaust, are experienced by nearly all investors at some point.

Fear and greed are two powerful forces in the human psyche and are at play in our capital markets. And while Brigadier General Ripper had a room full of generals and politicians frantically trying to avert the world's end, investment markets have advisors, asset managers, consultants, and traders trained to think rationally and help clients avert financial crises.

Throughout the history of capitalism, it has not been uncommon for investors to chase asset prices far beyond their intrinsic value. Such is the case with asset bubbles. As far back as 1841 when the seminal work by Scottish psychologist and journalist, Charles Mackay (1), first published "Extraordinary Popular Delusions and the Madness of Crowds," the author chronicles many of the pre-industrial-age asset bubbles up to that point. Mackay documents Dutch Tulip Mania (mid-1630s), the British South Sea Company stock scheme (1720), and the UK Railroad Mania (1840) which economic historians considered some of the first recorded economic bubbles. Within each,

HARTLAND UPDATE: Hartland has made the list of the Top 50 Fastest and Growing Firms in 2017.

According to the Financial Advisors RIA Survey and Ranking for 2017, Hartland has made the Top 50 list which was published July 2017.

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investors were caught up in the frenzy of the spiraling prices of tulip bulbs, a merchant ship trading company, and railroad shares of industrial England. All of them ended badly for participants.

Throughout these periods of irrational exuberance, greed overwhelmed fear and investors' expectations become disjointed from economic reality. Capital market structure, investor protection legislation, and the savviness of investors have evolved over time.

Successful investors are well aware of their innate human biases and limitations. They learn to synthesize current market facts with their emotional state to limit or spur the necessary reaction. This does not mean that even the savviest of market participants is completely rationale when making investment decisions. Nearly all investors are prone to allowing emotions, biases, and history periodically dictate their actions and not rely solely on proven economic facts.

So what does that mean for the average investor?

In 2014, Morningstar published the results of a study illustrating the average annual returns over a 10-year period for a typical investor (Exhibit 1). They compared the mutual fund returns for different asset categories (ie. US Equity, Taxable Bond), in the first column versus the returns that a typical investor experienced due to the timing of investing in each asset category, in the second column. The second column adjusts the mutual fund's underlying performance by the actual timing of cash inflows and outflows of each fund, thus calculating the asset-weighted returns. While fund returns tell us how good the manager is versus a benchmark, fund flows provide data on what investors are actually doing with their assets. The results are not encouraging. In short, during periods of market turmoil, investors generally sold their risky investments – after much of the market damage had been done – and were slow to reinvest. However, funds or asset classes with strong market returns were met by significant cash inflows the following year. The study's results showed an average investor's portfolio, represented by the All Funds row, likely underperformed a buy-and-hold strategy by roughly 2.5% per annum.

Exhibit 1:

| Asset-Weighted and Average Total and Investor Returns: Trailing Through Dec. 31, 2013 | | | |
|---|--|--|-----------------|
| | Average 10 Year Total Return (%) | Asset-Weighted 10 Year Investor Return (%) | Returns Gap (%) |
| US Equity | 8.18 | 6.52 | -1.66 |
| Sector Equity | 9.46 | 6.32 | -3.14 |
| Balanced | 6.93 | 4.81 | -2.12 |
| International Equity | 8.77 | 5.76 | -3.01 |
| Taxable Bond | 5.39 | 3.15 | -2.24 |
| Municipal | 3.53 | 1.65 | -1.88 |
| Alternative | 0.96 | -1.15 | -2.11 |
| All Funds | 7.30 | 4.81 | -2.49 |

Source: Morningstar.

Past performance does not indicate future results

To further illustrate investors' underwhelming results, the same Morningstar analysis highlighted 2012 mutual fund flows and the actual performance results of the subsequent 2013 calendar year (exhibit 2). Asset classes that saw the greatest fund outflows in 2012 generated the best investment performance in 2013. Asset classes that had large inflows witnessed flat to negative results the subsequent year.

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Exhibit 2:

| Flows in 2012 Show Poor Timing | | |
|--------------------------------|----------------------------|----------------------------------|
| | 2012 Flows (\$ Billion) | Subsequent Return 2013 (%) |
| U.S. Equity | -93,677 | 35.04 |
| Sector Equity | 3,264 | 18.90 |
| International Equity | 13,604 | 13.19 |
| Allocation | 20,399 | 15.40 |
| Taxable Bond | 269,760 | 0.15 |
| Municipal Bond | 50,313 | -3.40 |
| Alternative | 14,781 | -4.85 |
| Commodities | 1,365 | -9.10 |

Source: Morningstar.

A New Science

It was not until the late 1970s when investment theory caught up to the fact that not all investors solely use economic models, valuation techniques, or traditional fundamental investment tools. In 1979, two Israeli psychologists, Amos Tversky and Daniel Kahneman won a Nobel Prize for their work outlining how human emotions and biases influence their investment decisions and thus asset prices. Their theory led to the study of a new science called behavioral finance, proving that human investors put up “decision walls” that impede their vision when it comes to making optimal financial decisions.

Decision What?

Decision walls; the lens through which each independent investor looks to make their decision. H. Kent Baker, a professor of Finance at the Kogod School of Finance at American University, describes these walls in three ways:

- **Cognitive.** These are behaviors that are driven by how people think and how they view the world around them. Such is the case with investors that have a recency bias where they put greater weight on recent events, trends, or investment results and assume these will persist longer-term. Other common cognitive biases include:
 - **Overconfidence Bias** – Unwarranted belief and faith in one’s abilities and reasoning.
 - **Illusion of Control Bias** – Investor tendency to believe one can influence or control an outcome over which one has no impact
 - **Mental Accounting** – Compartmentalizing investments instead of viewing in totality or in a portfolio context
- **Emotional.** These are behaviors that are driven by how people react to what is happening around them. Common emotional biases include:
 - **Loss Aversion Bias** – The fear of loss overpowers the willingness to seek gain. Being inclined toward risk-averse behavior even if financially not optimal.
 - **Status Quo Bias** – Fear of any change. Facing choices, willingness to stay with current investments, even if they do not fulfill needs or are ideal.
- **Social.** Yep, good old fashioned peer pressure. Common social biases include:
 - **Herd Mentality** – Following the leader. Either through investing in what is hot, or avoiding out-of-favor areas simply because it is in vogue.
 - **Confirmation Bias** – Selectively choosing information and opinions that reinforce existing beliefs or conclusions.

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So how do investors avoid decision walls or investment biases?

There are a number of steps that can be taken to avoid major portfolio destruction caused by human emotions and biases:

1. **Create an Investment Policy Statement** – To stay grounded, have written portfolio guidelines that include objectives, risk tolerances, liquidity needs, time horizons, tax implications, unique requirements and other relevant factors.
2. **Incorporate regular portfolio rigor** – Consider using a purpose-driven asset framework as well as periodic scenario and stress testing in portfolio analysis. View and compare results using a risk-adjusted framework against appropriate benchmarks.
3. **Acknowledge and learn from past mistakes** – Be aware of your own biases. Base investment decisions on facts, seek professional opinions, and evaluate your expectations.
4. **Seek or maintain professional investment help** – Working with a professional investment advisor or consultant can keep your finger off the nuclear button.



“Sir, I have a plan.”

The closing line in *Dr. Strangelove* appropriately doubles as the best defense against our Behavioral Finance shortcomings.

- Have a plan. A detailed Investment Policy Statement will suffice.
- Work the plan. Stay focused on portfolio objectives and policy tolerances.
- Review the plan and portfolio regularly with your investment advisor. Adjust as warranted.

Footnotes:

1. *Dr. Strangelove*. Stanley Kubrick. Columbia Pictures, 1964
2. Charles Mackay, *Extraordinary Popular Delusions and the Madness of Crowds* (London, 1841)
3. Russ Kinnel, “Mind the Gap 2014: Some investors get caught leaning the wrong way, again,” *Morningstar*, February 27, 2014, <http://news.morningstar.com/articlenet/article.aspx?id=637022>
4. Michael M. Pompian, CFA, CFP, *Behavioral Finance and Wealth Management* (New Jersey: Wiley Press, 2006)

MARKET BENCHMARK RETURNS

| June 30, 2017 | | 1M | 3M | 12M | YTD |
|----------------|--------------|-------|------|-------|-------|
| US Large Cap | S&P 500 | 0.3% | 3.0% | 16.2% | 11.9% |
| US Small Cap | Russell 2000 | -1.3% | 2.9% | 14.9% | 4.4% |
| Developed Intl | MSCI EAFE | 0.0% | 2.7% | 17.6% | 17.0% |
| Emerging Intl | MSCI Em Mkt | 2.2% | 9.4% | 24.5% | 28.3% |
| Real Estate | NAREIT | 0.6% | 3.9% | 2.8% | 7.4% |
| Core Fixed | BarCap Agg | 0.9% | 1.2% | 0.5% | 3.6% |
| Short Fixed | BarCap 1-3Yr | 0.2% | 0.4% | 0.9% | 1.2% |
| Long Fixed | BarCap 10+Yr | 2.2% | 3.3% | -1.1% | 8.7% |
| Corp Debt | BarCap Corp | 0.8% | 1.8% | 1.9% | 5.3% |

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.