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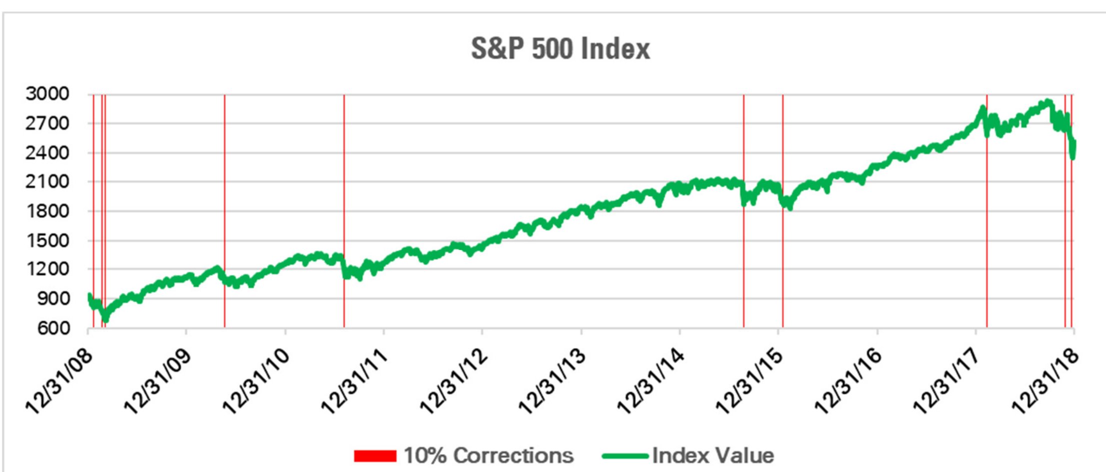
Rush Hour and Short Cuts

Would you rather be stuck in rush hour traffic or rebalance your portfolio? That's an odd question, no doubt. But odder yet is that fact that 31% of investors in a survey said they would rather be stuck in traffic than rebalance their portfolio.[1] As an investment adviser who just rebalanced its clients' portfolios at year-end, we find this response disappointing because systematic rebalancing is one of the few opportunities in the markets that is nearly a "free lunch."

Year-end 2018 was an opportune time to rebalance portfolios. The U.S. stock market declined 13% in the quarter. International markets declined 11% for the quarter and 14% for the year. Rebalancing back into equities after such a significant decline allowed us an opportunity to buy at a lower price than before, and we believe this will lead to a higher risk-adjusted returns over time.

Even though the fourth quarter 2018 correction seems significant, the reality is that such significant corrections are surprisingly commonplace. Just in the last ten years, there have been ten instances when the market has declined at least 10% from a nearby peak as shown in the graph below. It is noteworthy that an investor who was steadfast through these declines experienced a 10.7% return per year, excluding dividends, a handsome reward indeed.

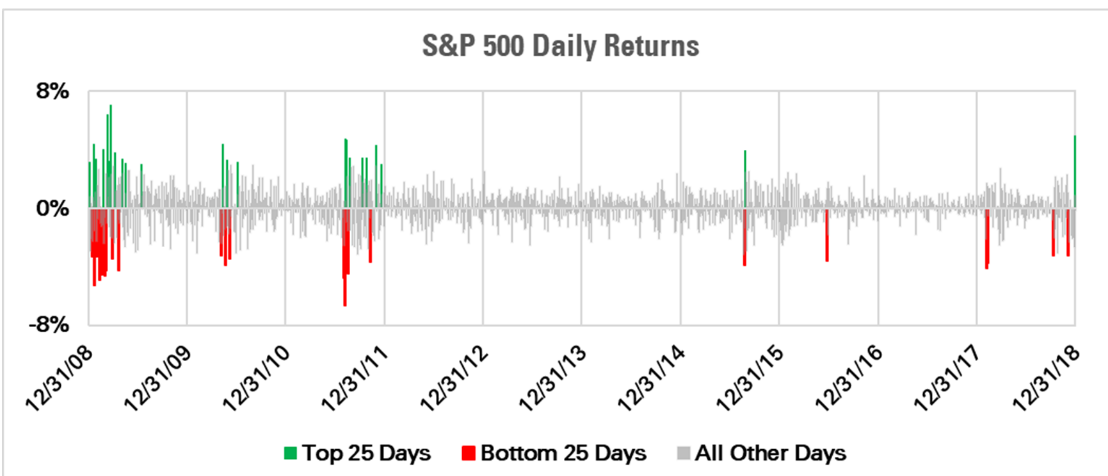


Source: High Pointe Capital Management

[1] *"Wells Fargo/Gallup Survey: Investors Expect, But Not Sweating, a Stock Market Correction"* published on September 28, 2017

Even though it seems like common sense to hold steady through market ups and downs, except for periodic rebalancing to buy the assets that have underperformed, evidence shows that most investors actually do the opposite. They buy assets that have outperformed in the recent past and sell those that have underperformed. This reactive behavior costs investors dearly. A study[2] done by researchers at the University of Nebraska and Iowa State University found that investors cost themselves 1.56% per year by buying shares of mutual funds that had outperformed in the past and selling shares of mutual funds that had underperformed.

The reason it is difficult for most people to time the market can perhaps be understood by examining the data in the chart below. It shows the daily performance of the S&P 500 stock index. We have highlighted the 25 best performance days in green and the 25 worst days in red. These are the days that had the potential to create euphoria or panic in the minds of naïve investors. It is interesting to note that the best and worst days seem to be clustered in narrow bands. So, an investor hoping to time the market successfully would have needed to go from highly optimistic to highly pessimistic and back to being optimistic over a short period of time. We would venture to guess that few such investors exist.



Source: High Pointe Capital Management

One of my academic heroes and a Nobel laureate, Daniel Kahneman, wrote a book entitled *Thinking, Fast and Slow* to explain how human beings make decisions. His writings have the potential to explain why investors might make decisions that are harmful to their portfolios. Kahneman writes that the human brain seems to work in two ways. The first, labeled System 1 Thinking, is to make decisions quickly based on intuition, short cuts, and emotion. The second, labeled System 2 Thinking, is slower, analytical and logical. We would argue that naïve investors' decisions to time the market are probably driven by System 1 thinking based on short cuts and emotions. Kahneman's framework can also explain why some quantitative investors have had better luck timing the selection of individual stocks rather than timing the broad market. This form of timing is known as momentum investing and its practitioners often use detailed analysis of historical data to make their decisions. In other words, they use System 2 Thinking rather than emotions and short cuts.

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2 *"Mutual fund flows and investor returns: An empirical examination of fund investor timing ability" by Geoffrey C. Friesen and Travis R.A. Sapp, September 2007, CBA Publications, University of Nebraska*

There is one more noteworthy aspect of the kind of market declines experienced in the fourth quarter of 2018. These events present opportunities to harvest tax losses, especially those of the short-term variety, thus lessening the tax burden. This is exactly what we did in December 2018 and we do not expect our investors to incur any significant tax liability associated with short-term capital gains for 2018.

The year 2018 was indeed a difficult one for investors all around but it highlighted that some conventional principles of good investing are still valid, namely, having an asset allocation policy that allows you to sleep at night, using market declines as an opportunity to rebalance back to the target asset allocation, and being alert to harvest tax losses to reduce the tax burden.

So, the next time you are stuck in rush hour traffic, tune out the "noise" on your radio about the daily up and down of the stock market and remember that there are no short cuts in investing.

Gautam Dhingra and Chris Olson
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