The Quarterly Report

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INSIDE STORY

The Psychology *of* Investing

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THE PSYCHOLOGY *of* INVESTING

On March 17 of this year, I explained in a client meeting that the market was in the process of bottoming, and the client asked how I could possibly say that. The COVID-19 crisis was raging with no clear end in sight, the economy was shut down, and the unemployment rolls were filling faster than in any time in history. How could I possibly be thinking that the market was bottoming?

The market, as it turned out, was indeed bottoming then and hit the very bottom just four trading days later. How did I know? After doing this for 28 years, I understand that investing is part rational science and part art. The science of investing we talk about a lot: analyzing companies from the bottom-up and estimating their actual value; comparing that value to the current market price; asking questions like, What is this company's competitive advantage? What is the potential for growth? These things can be quantified and put into a model.

The art? That is a different story. The art is about judging where investors are in the cycle of market psychology. It is emotion, not reason, that drives the market on a day-to-day basis. The longer one is in this profession, the better he gets at reading the emotions of the market, and by March 17 this year, the market was just about done with its downward emotional cycle.

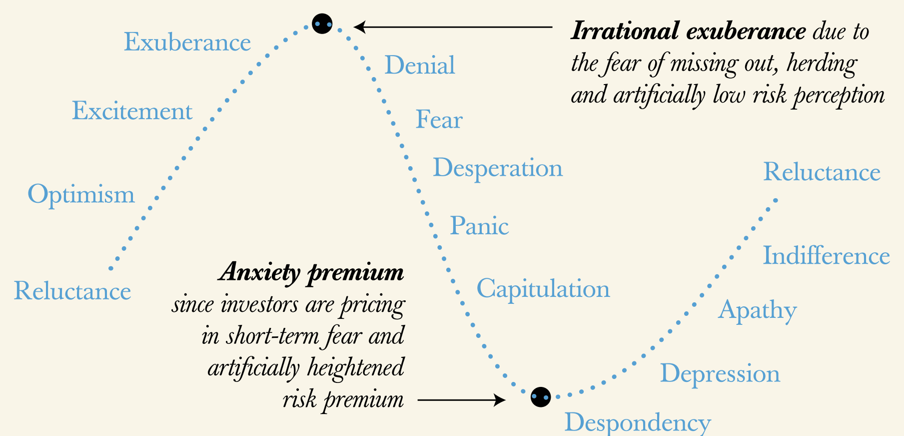
One of the best descriptions I have ever heard about the emotions of the market came from a presentation at the 2012 CFA Institute Wealth Management Conference. A gentleman by the name of Greg Davies with Barclays gave a presentation entitled, "Utilizing Behavioral Finance in the Management of Client Portfolios." Davies showed a chart that reflects the ups and downs of the market and the emotions investors feel at each stage.

The first step for most investors is reluctance. Making an investment takes a leap of faith; everything we can possibly know about any investment is in the past, and our results will be completely determined by what is in the future. The future is unknowable, and while we do everything in our power to put probabilities on our side, anything can happen tomorrow. This uncertainty makes investors reluctant, and when the market pundits start talking about uncertainty, that is a good sign that we are in the beginning of a bull market run.

As the market climbs, investors start to grow in optimism. Maybe their reluctance was misplaced. Events certainly seem better than expected, so confidence begins to grow. The market uptick starts to accelerate and people begin to believe that maybe the future isn't so uncertain. Things look positive, at least from a market perspective.

This positivity grows until the optimism turns into excitement. The investors who were brave enough to overcome their reluctance are now bragging about their portfolio gains. The news is highlighting record highs for market indices. Everyone starts talking about their 401(k) and how they will be able to retire in two more years if this keeps up. The excitement is contagious. The wealth effect causes people to spend more out of their income, even though rationally their

Investor Behavior Studies*



** Source: Greg Davies, Utilizing Behavioral Finance in the Management of Client Portfolios, 2012 CFA Institute Wealth Management Conference*
Hersh Shefrin and Meir Statman. "The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence." Journal of Finance 40(1984):777-790

investment market values and their income are two separate items. The economy picks up because people are excited and spending money. Experts say things like, the market forecasts six months in advance and was telling us months ago about this wonderful economy. Those investors were not uncertain at all, they were "right" about this bull run.

Now the excitement becomes exuberance. Exuberance is actually closely related to reluctance; both are forms of fear. Our investor started out reluctant because she feared the unknown, now she fears missing out. All of her friends are making money hand over fist, and she now really needs to get in on this game. This is when the average lay investor finally gets into the market. This is when clients call us and say, "You know what, I think I should be taking more risk than I have been." This is when experts start saying, "This time it is different. We know the future is bright." This is the top.

Of course, once we are at the top, there is only one place to go. The market starts heading back down. The first reaction to the downward market is denial. We all know that investing wisely is a long-term activity. We are in it for the long haul, and this is just a market hiccup. There is nothing to worry about; in fact, this is a buying opportunity.

Yet, the market keeps dropping. The denial turns to fear. Could I lose everything? Will I still be able to retire? I know I am supposed to ride it out, but this is really scary. The future is once again uncertain, but I know this is what investing is like, so I'll ride it out. Ride it right into desperation. I used to have a 401(k) but now it is a 201(k). I'll never be able to retire. I'm just a really bad investor.

The desperation can go on for some time, or it can be really short-lived, but ultimately what follows is panic. This is when the client who called a few months ago wanting to increase his risk exposure all of a sudden wants to pull the plug. My portfolio is down X amount and we can never make that up. Now the anti-wealth effect hits and people stop spending, even though rationally their investment market value and their income are two separate items. The economy slows and the perma-bears who predicted this market downturn along with the last three and 20 others that didn't happen (they usually fail to mention those) start talking about how the future is certain and it is bleak.

The lay investor can no longer take it; the capitulation has begun. There is a great washout, every last long-term holder of investments gives up, and the market crashes to new depths. This is the bottom. This is precisely the time the best investors start to buy, and buy aggressively. The market starts to rise, but we have been through an emotional roller coaster and we have landed in the territory of despondency. I have lost all that money. I can't believe it, this is just horrible. It is all a big scam.

The despondency gives way to depression. The market is quietly ascending while people are still not spending money; the economy is horrible, the market is "disconnected from reality," life is depressing, and the market is going to go down again. Except it doesn't. It doesn't drop in 2010 after the rally in 2009 and it doesn't go back to the March 23 low today. It keeps climbing.

Apathy sets in: I was never going to retire anyway, it doesn't matter. Apathy gives way to indifference: Oh, the market is up today, who cares? Just a bunch of Wall Street guys gaming the system, don't they know how bad it is out here? But, as the market continues to rise, indifference finally gives way to reluctance, and we are back where we

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REVIEW *of* ECONOMY

The 1st quarter 2020 GDP growth came in at down 5 percent, which under any other circumstances would be horrible, but in this world that was much better than expected. 2nd quarter expectations remain very pessimistic, in our view too pessimistic.

The official unemployment rate is 11.1 percent in June. Again, a horrible number under normal times, but experts thought it would be 20 percent or higher. Two reports in a row have seen the rate drop significantly.

Inflation is 0.1 percent based on the latest consumer price index report. Oil has normalized which has gotten us out of deflation, but we are a long way from the 2 percent Fed target. Expect the Fed to continue to be very aggressive. +

REVIEW *of* MARKET

The market bounced back. For the quarter the S&P 500 finished up 20.54 percent and small company stocks represented by the Russell 2000 index were up 25.42 percent. Growth outpaced value dramatically.

Bonds were up for the quarter. The Barclays US Aggregate Bond index ended up 2.90 percent. High yield bonds rose10.18 percent.

International stocks rebounded as well. The EAFE index finished up 15.08 percent while the MSCI Emerging Markets index ended the quarter up 18.18 percent. +

MARKET *forecast*

We have come back a long way and done so very quickly. The economy continues to provide positive surprises, which leads us to be cautiously optimistic. This remains a stock pickers market, as some companies will emerge stronger and some will not emerge at all.

Small company stocks still have more room to run, but that will depend on the economy. If the economy remains weak large companies will be the safer place to be. International stocks have not come back as far and may be better values.

Bonds make no sense at these prices. High yield bonds may be the only place to get positive long-term returns. +

» *Continued –*

started. The lay investor does it all over again.

So, back to the original question. How did I know that the market was bottoming on March 17? First, I didn't. I thought is was, but I have been doing this for 28 years. If you wanted to talk to me when I "knew" what the market was going to do, you would need to go back in time at least 26 years when I was still young and unaware of what I didn't know. I thought we were bottoming because market activity looked like capitulation, and capitulation always marks the bottom.

I did not know it would be a v-shaped bottom; in fact that is not what I thought at the time. I thought we would bounce around the bottom a little longer, but I also knew that I could be wrong. We moved forward prudently, but with the idea that the bottom was either here or very near.

Today, I am fairly optimistic as far as the market goes. Why? Because I keep hearing pessimistic voices. I'm not sure exactly where we are on the emotional rollercoaster, but it is somewhere between despondency and reluctance. This gives me confidence.

Understanding the psychology of the market can be a great tool, especially when added to a scientific approach. Investing is part science and part art; it is not 100 percent either of those things, and do not let anyone convince you otherwise. Quantitative approaches that try to make it all science tend to do very well until they completely blow up, while those who think it is just an art and go with their gut tend to blow up even faster. Wise investors understand it is both.

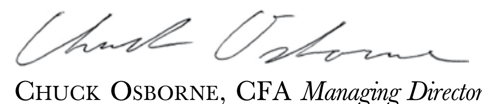
This leads me to the final thought on the subject: Every investor is subject to this emotional rollercoaster. There is no immunity. Being a professional and having 28 years of experience does not make me immune; I feel these emotions just like everyone else. The difference is being aware of how one's emotions are affecting him at the time. The two important ones are reluctance and denial.

We put various rules in place in our process to overcome reluctance and denial. If an investor can overcome reluctance, then she can take advantage of the sharpest assent in the market; this is very important for long term results. Likewise, if she can overcome denial, then she can be defensively positioned during the worse of the downturns; this allows her to be far more clear-headed while others are capitulating, creating great opportunities for those who can once again overcome their reluctance.

The cycle continues. This is not to say that everything remains the same, or that it isn't different from time to time. The dot-com bubble cycle took place over at least six years, from 1997 through 2003. It was slow and drawn out. The bubble burst in March of 2000 and the bear market did not bottom until halfway through 2003. The financial crisis hit in early 2008 and bottomed in March of 2009. The COVID crisis went from denial to capitulation in a month. One cannot mark these cycles with a calendar, but in each case, the downturn starts with denial and ends with capitulation.

I understand the human desire for everything to make sense. We want logical explanations. Every day the pundits make up reasons for what the market did. The truth is that the market is made up of people, and people are emotional, not rational. Understanding what those emotions are and how to recognize them helps investors flow with the market cycle instead of trying to fight it. That is the art of investing.

Warm Regards,



Chuck Osborne, CFA *Managing Director*