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FOCUSED ON WHAT MATTERS MOST.

Investing Logically Is Simple, But It's Not Easy

By Steve DeBoth

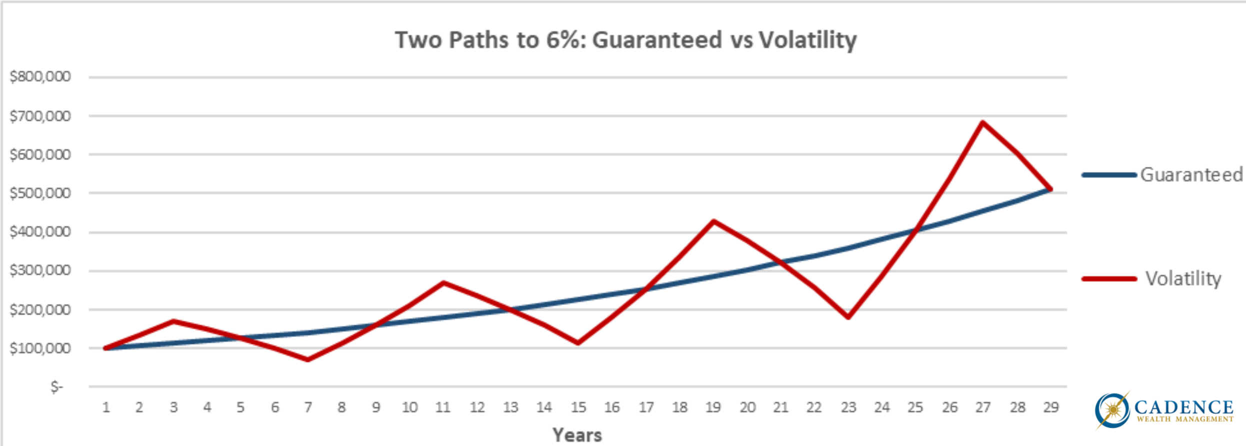
Despite the vast majority of investment advice saying to invest logically, it is difficult for investing not to be emotional. When your ability to afford your wants and needs depends on your investment returns, completely or just in part, how could it not be? It's one thing to feel these emotions, especially since it may be impossible not to, but it's not impossible to avoid acting on them.

Acting on these investment emotions very often leads to bad outcomes, during both bull and bear markets. When bull markets cause investments to grow rapidly, many people start to chase those that are performing the best. This quite often leads to people piling in to overvalued investments at the exact wrong times. Think of how many people loaded up on tech stocks in 1999 and early 2000, only to watch those investments get crushed. Committing a large percentage of your resources at the peak of any market is a well-known recipe for disaster.

The flip side of that coin is when investors sell out of their investments during bear markets because they cannot emotionally take it anymore. Millions of Americans sold their stocks in late 2008 and early 2009 after those investments had already lost -40% to -50%. Given the zig-zag nature of stock market recoveries, there's an extremely small chance those who panicked got back into the market before they had already locked in some of those losses forever.

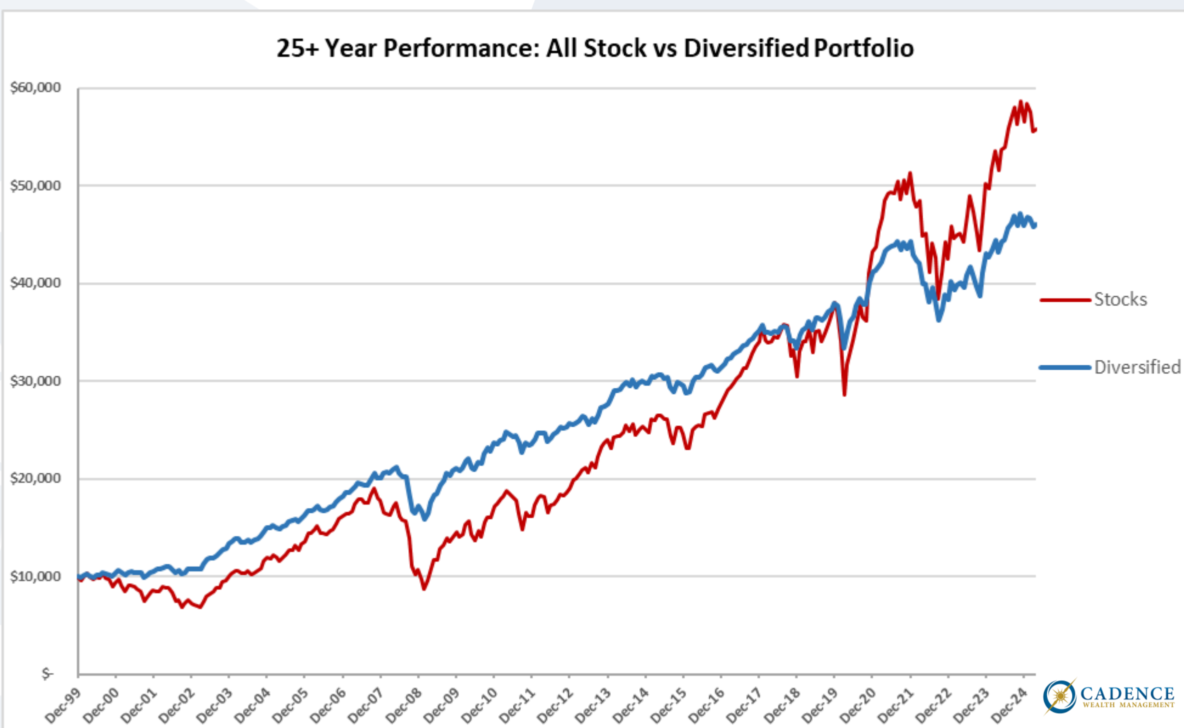
Feeling like you're missing out on runaway investment returns, wanting to add to the aggressive side of your portfolio when it is growing by leaps and bounds, and worrying about how bad it can get during a market crash are all very understandable reactions. So, how do you behave rationally in an activity that is undeniably emotional?

For starters, you have to identify your tolerance for loss, construct your portfolio around that, rebalance annually, and monitor yourself along the way. While Cadence advisors can do that with and for you, what we cannot do is fully control your fear or greed, because you will experience both in the same investment portfolio. Consider two investment portfolios. One guarantees a 6% return year-in, year-out, whereas one targets a 6% return but will experience volatility along the way.



There are years in there, especially years 3, 11, 19, and 27 where you might feel tempted to get more aggressive. Likewise, there are years in there, especially 7, 15, and 23 where you might feel like your plan isn't working. There you have it: fear and greed in the same portfolio. Were you to choose the more volatile investment mix, you would have fallen short 35% of the time. Those odds are probably not good enough for most people to take the unneeded risk, and therefore it's a pretty easy decision to lock that 6% return in and avoid the 35% chance of coming up short if you had to choose between these two investments. Probably.

But what about in reality, where there is no guaranteed 6% investment? Two common ways investors try to hit a return goal is to construct a portfolio that tries to target it specifically, and another is to reach for a higher return, fall short of that, but still earn at least their target. Consider an investor facing this decision on New Year's Eve, 1999. Stocks all around the world are going crazy, the Internet seems to be reshaping both the economy and the investment markets, and all you need to earn over the next 30 years is 6% per year. Why would you not put your money in the stock market instead of a more modest portfolio? In this case, let's look at a diversified portfolio of stocks, bonds, and alternatives targeting around 6% per year versus a portfolio of all stock market indexes, both foreign and domestic, which is targeting around 9% per year:



In this example based on actual historical returns, a diversified stock portfolio targeting 9% since 1999 had a higher value than the more conservative portfolio only 20% of the time, and only since 2020. There were some sizeable losses, and a much less volatile investment portfolio would have avoided many fearful moments. Even though the end result here is that investing in an all-stock portfolio did return more after 25 years than the more diversified portfolio, all it would take from here is for stocks to drop -24% and the more conservative mix once again may have returned more, depending on how much all the various investment categories are dropping. Considering a loss of at least -24% has happened four times the past 25 years for an all-stock portfolio, and considering US stocks are by many measures more overvalued today than at any point over this timeframe, where would you rather be over the next 5 years? Something much more conservative than an all-stock portfolio, or would you take your chances?

In the end, the all-stock portfolio did fall short of its 9% target, earning 7.03% per year on average, while the more diversified portfolio returned 6.22% on average. Both approaches did achieve the 6% target, though the more volatile one may have been a lot harder to stick with, and it looks likely to suffer some big losses in the not so distant future. Despite achieving the 6% per year goal, a problem with the more diversified investment mix is that at almost any point in time, you could have found an investment that was beating that diversified mix. First it was alternatives between the tech bubble and the great recession, then it was bonds for four or so years, and then after that it was stocks. Fighting off the greedy desire to overload in any of those investments at those times may have been difficult. Likewise, even this diversified investment mix was down -25% at its worst, so the potential to have to push through fearful moments without abandoning the plan still existed, even in a well-designed, properly performing investment mix.

Following an investment plan requires patience. Long-term plans have to handle short-term results, and you may frequently feel disappointed even though you are succeeding. Why have this investment mix when everyone else seems to be making more? Why have this investment mix when it's had several bad years? All of that is going to happen, and all of the potential emotions that come with that are going to be present. A properly diversified asset mix that conforms to your needs for safety and growth can still have rough patches, and probably will. The test is if you can avoid abandoning your plans when it feels like you're not making enough, or when you feel you're losing too much. Acting logically instead of emotionally is simple, but it's not easy. If you are ever going to act on fear or greed, it's probably better in the long run to act greedy when you feel fearful, and act fearful when you feel greedy. When it comes to investing, human nature has an uncanny way of getting wrong when to feel those two things, and frequently acts accordingly, to an investor's detriment.

Consensus

By Casey Clarke

"Experts say recession risks are overblown." "The drop in stocks should be temporary. Experts recommend buying more shares." "Tariffs are bad and incredibly disruptive to corporate profits, but somehow earnings should be okay; better than expected in fact." "The investable universe is still, and should always remain, stocks. Buy, buy, buy!"

Achieving consensus is important – a core democratic principle in fact. How else would we make group decisions fairly, that accurately reflect the will of the masses? Without requiring it, we'd be paralyzed by doubt, bickering, and inaction. After all, it's often easier not to take action than to change course and do something differently. Seeking a consensus allows us to take action in a way that we can feel confident in and good about – mostly. It gets us off the block.

That's not to say, however, that consensus is perfect. Salem Witch Trials, anyone? There's a little patch of woods in the town of Ashland near where I live where it's said that a family or two of "witches" fled persecution, and almost certain execution in Salem, to live in small caves in the glacial till until things calmed down. The road bordering that hiding spot now bears the name "Salem End Road", as it's also said that those families, when safe to do so, set up homesteads on the edge of that land. I'll bet if we were able to talk to those "witches" today, they'd probably have something to say about how consensus in Salem back in 1692 let them down. There are, of course, countless examples of this over time. Part of appreciating the gravity of this failure, and its high probability of happening again in modern day, is understanding and acknowledging that the people involved were no less intelligent, or human, than we are now. We are the same.

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, one by one." - Charles MacKay, Extraordinary Popular Delusions and the Madness of Crowds (1841)

The problem, when it comes to finance and markets, is that we often prioritize feelings over facts, whether consciously or not. Asset prices rocketing to dizzying heights doesn't happen because investors are calculating and thinking – there is almost no prefrontal cortex activity taking place. Rather, it happens due to excitement, exhilaration, and greed. The same is true on the flip side when markets have sunken to previously unthought of lows. Most are not calculating how great future returns could be at such low starting points, but rather avoiding the prospect entirely because of feelings of despair and fear. We are emotional creatures, and when we are experiencing similar emotions to the rest of the herd, we are primed for big, big mistakes.

Since we are emotional beings, and crave support and validation from others, we are entirely capable of, and susceptible to, making sub-optimal decisions organically, all on our own. But, what happens when we are nudged or tricked into thinking a certain way? The quotes at the top of this piece reflect the reality as we see it that exists in the financial services industry. There is never a bad time to own stocks, not because there aren't times when investors can lose a life-altering amount of money, but because if the masses decide it's not a good time to own stocks, financial services firms would take gigantic hits to their bottom line. Thus, buy and hold, don't time markets, there are no good alternatives. Many believe these things not realizing the perverse financial incentives driving them and conflicts of interest around questioning them. I would argue that the magnitude and half-life of a delusion is proportional to the magnitude of the incentives driving it, which is to say, if there is tremendous money to be made from a deluded crowd, we will have a deluded crowd.

So, what are we to make of this? Is consensus good or bad? Ah, the dissonance we struggle so much with. Like many other things in life, we'd prefer it to be simple – black and white, red or blue – pick a team for Pete's sake. It's both. Consensus is both important and problematic. What we all need to recognize is that the crowd can be wrong, and in some cases very, very wrong. There are a host of reasons for this from emotional, well-intentioned, organic reasons to more pernicious, calculating, and manufactured reasons. A good litmus test for discerning when the crowd might be off track is first assessing the conflicts of interest and incentives of the parties benefiting from the message or narrative, then evaluating the level of rationality versus emotion behind it. Take the Salem Trials, for example. The desire for strict, Puritanical religious adherence by the magistrates and village leaders, the deference to Cotton Mather as dark spirit expert as well as Mather's desire to validate his "expertise" around witchcraft, and allaying the people's fears through swift action likely all played a role. This, all on top of a population that faced plenty of internal conflict and dispute that likely left them emotionally primed for a delusional herding event.

Closer to home, we can take any number of stock market bubbles from the past and apply the same process. Who had an interest in growing them, were investors primed to play along, and were they using their prefrontal cortex or amygdala for decision-making? Hint, if someone can't get through a line of basic questioning or explain the rationale behind their actions, they're using their amygdala. There are very few rational explanations as to why one would make Bitcoin or Nvidia 50% of their investment portfolio.

There are two advantages to recognizing when the herd is thundering down the wrong path…

- You can avoid running yourself right off the cliff.
- You can spin around and look at what the herd is running from, or leaving behind, and apply your logical brain power to those things. Amygdala, off!

Our clients and readers know well what we're referring to here. Every market mania leaves whole categories of assets neglected and fertile for future growth. If one extracts oneself from the herd, she can take advantage of this. To do this requires one to be a bit skeptical – to have that instinct to look over the opposite shoulder when you feel a tap from behind – to look in the opposite direction of where someone might be annoyingly insisting you continue to look.

The world and markets are volatile, and emotions are running incredibly high. This very fact alone requires us to be more self-aware than we otherwise might be. If we find ourselves looking for too long in one direction, seeking consensus, we're likely part of the herd.

"We find that whole communities suddenly fix their minds upon one object, and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first." - Charles MacKay, Extraordinary Popular Delusions and the Madness of Crowds

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