Understanding the Human Nature of Irrational Decisions May Be Key to Protecting Client Assets

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Although the major indices are well off of the lows they reached in March, there remains a high level of uncertainty about what the future holds for the market and the economy. The S&P 500 (SPX) was down more than 1% in back-to-back trading sessions on Tuesday, May 12 and Wednesday, May 13. Also on Wednesday, Federal Reserve Chairman Jerome Powell said that "The scope and speed of this downturn are without modern precedent, significantly worse than any recession since World War II" and warned that "There is a growing sense that the recovery may come more slowly than we would like...and that may mean it's necessary for us to do more" (Source: *The Wall Street Journal*). At the same time, the financial press has also been putting out headlines like "Why 'the next big shoe to drop' in the U.S. Economy could hit by July."

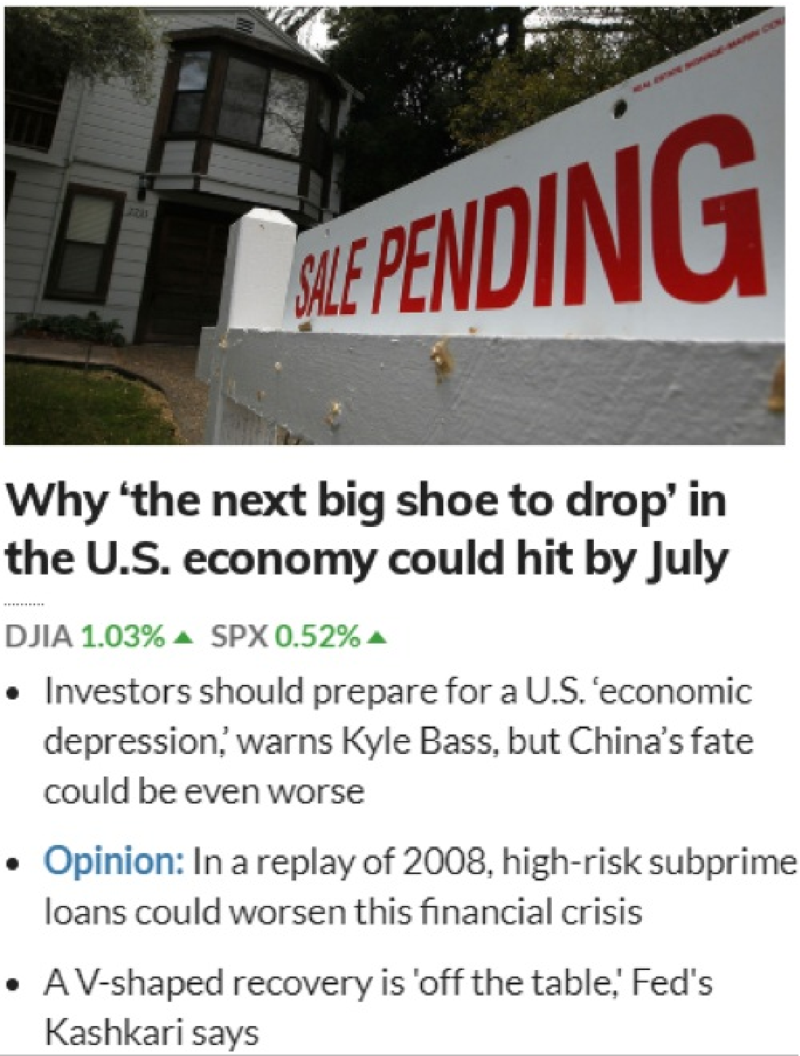

Image Source: MarketWatch

Although it's typically not in our best interest, many of us allow our emotions to impact our investing decisions under the best circumstances. And given the current state of affairs, even the steeliest of investors may be feeling uneasy. One reason that we tend to let our emotions get the best of us in the context of investment decision making is that we tend to feel the pain of losses to a greater extent than we do the joy of gains.

“Maybe life is the hard way, I don’t know. When the show was great, it was never as enjoyable as the misery of the show being bad. Is that human nature?” –David Letterman in a 2016 interview with *The New York Times*. This tendency - to feel the impact of losses more acutely than gains - is described in prospect theory and it has important implications for our investment behavior. From the Investopedia entry on prospect theory:

According to prospect theory, losses have more emotional impact than an equivalent amount of gains. For example, in a traditional way of thinking, the amount of utility gained from receiving $50 should be equal to a situation in which you gained $100 and then lost $50. In both situations, the end result is a net gain of $50.

However, despite the fact that you still end up with a $50 gain, in either case, most people view a single gain of $50 more favorably than gaining $100 and then losing $50...

...Prospect theory also explains the occurrence of the disposition effect, which is the tendency for investors to hold on to losing stocks for too long and sell winning stocks too soon. The most logical course of action would be to hold on to winning stocks in order to further gains and to sell losing stocks in order to prevent escalating losses.

When it comes to selling winning stocks prematurely, consider Kahneman and Tversky's study in which people were willing to settle for a lower guaranteed gain of $500 compared to choosing a riskier option that either yields a gain of $1,000 or $0. This explains why investors realize the gains of winning stocks too soon: in each situation, both the subjects in the study and investors seek to cash in on the number of gains that have already been guaranteed. This represents typical risk-averse behavior.

Left unchecked, the disposition effect creates a host of problems in our investment decision making. We hold on to the losers because if we don't actually sell them, then we won't have to realize the loss, and we think we are avoiding some measure of pain. And the winners, we often sell them too soon (even if it means missing out on additional upside) because we fear to see those gains evaporate.

As an advisor, understanding the irrational decisions that human nature can produce is critically important both so you don’t fall victim to it and so you can protect your clients from doing the same. And in times like these, when emotions are already heightened, being cognizant of these potential pitfalls is especially important.

The rules-based tools on the Nasdaq Dorsey Wright (NDW) Research Platform can help you avoid these pitfalls. However, these tools can only provide a road map, it is incumbent upon you to coach your client to make sure they don't let emotion take over and veer off course.

One tool we’ve found incredibly helpful for explaining why our processes makes sense is Jim O’Shaugnessy’s “What Works on Wall Street: The Classic Guide to the Best-Performing Investment Strategies of All Time.” Hearing from a third party can help instill confidence in clients and the summary of findings within the book establish a good case for constructing equity portfolios using relative strength and using it in a systematic fashion. A few of our favorite quotes from the book are below.

"The only way to beat the market over the long term is to use sensible investment strategies consistently...The lack of discipline devastates long-term performance."

As the prospect theory shows us, psychology can very often get in the way of optimal investment decision making. By implementing (and sticking to) a rules-based relative strength system for investing, we can avoid making emotional decisions. Relative strength is calculated simply by dividing the price of one security by another on a daily basis, and that calculation comes to life once we plot it on a Point and Figure (PnF) chart. At any point in time, a PnF chart is either on a buy signal or a sell signal. There is no gray area, allowing the practice of constructing relative strength-based portfolios to be conducted in both a "sensible" and "consistent" manner.

Using research conducted by third parties like James O'Shaughnessy and others is always helpful in establishing credibility for the process. O'Shaughnessy gained access to the Compustat database and tested everything that had been purported to work (market capitalization, P/E ratios, price-to-book ratios, price-to-cash flow ratios, price-to-sales ratios, dividend yields, earnings per share, profit margins, return on equity, and relative strength) over a long period from 1951 to 1996. He tested them independently and in conjunction with other variables. In summary, he found that there was only one factor included in all of the top 10 performing strategies over time, and that factor was relative strength. In addition, he pointed out that the worst strategy he tested was the anti-relative strength strategy of bottom fishing (or buying the stocks with the worst trailing performance).

"...For investors, this means letting good strategies work. Don't second guess them. Don't try to outsmart them. Don't abandon them because they're experiencing a rough patch. Understand the nature of what you're using and let it work...it is only by being dispassionate that you can beat the market over time."

Keeping our emotions under wraps is never easy. It's even harder in an environment like this one where there are plenty of legitimate causes for concern and there seems to be an unending series of negative headlines. But, it's times like these when making rational, logical decisions is of utmost importance. Hopefully, having a better understanding of what drives some of our irrational decision-making will help aid you in keeping your clients on course.

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