Mitch on the Markets

An Investor's Worst Enemy!

By Mitch Zacks
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There are several reasons an investor may underperform over time: poor stock selection, suboptimal asset allocation decisions, mistimed trades, *too much* trading, switching managers too often, and so on. But often times when it boils down to it, an investors' worst enemy – almost always – is him or herself.

The field of behavioral finance is dedicated to understanding why and how investors get in their own way so frequently, and there is no shortage of in-depth research addressing the issue (trust us, we've read a ton of it). One particular bit of research conducted by DALBAR showed that from 1997–2016 (20 years), **the average investor's annualized return was a meager +2.3%**. That's devastatingly low, but it is even more heart wrenching to learn that the S&P 500's annualized return *over the same period* was +7.7%. The implication here is that investors are foregoing 20 years of 5% compounded interest, which could easily mean millions of dollars in opportunity cost. Not good.

Dozens of books have been written about why investors have a tendency to underperform so often, and by so much. But, one mistake I want to briefly address in this column is how investors react to positive news versus negative news, and why it matters.

Investors Mistakenly Care More about Negative News than Positive News

In my view, investors make the most mistakes when they make strategy changes in response to negative news. And therein lies a major problem for many investors: *at any given time, there is far more negative news than positive news*. The implication is that investors are constantly being tempted to make knee-jerk decisions to sell stocks or to suddenly switch an investment strategy, which can lead to underperformance over time.

Just think about the slate of negative news in circulation today:

- The bubbling threat of war with North Korea

- Major banks warning of an impending recession, as I wrote about last week
- The looming possibility of a government shutdown
- The receding likelihood of comprehensive tax reform happening this year
- Stocks approaching over-valued territory
- Low inflation inhibiting the Fed's ability to raise rates

Any of these stories is capable of making an investor reluctant to stay invested in stocks, but only if no consideration is given to the positive news stories happening at the same time:

- U.S. GDP grew *faster than expected* in Q2, at an annual rate of 3.0%
- The acceleration in real GDP in Q2 primarily reflected upturns in private inventory investment, increases in personal consumption expenditures (PCE), and increases in nonresidential fixed investment that were larger than previously estimated
- Profits from current production (corporate profits with inventory valuation adjustment and capital consumption adjustment) increased $26.8 billion in the second quarter, in contrast to a decrease of $46.2 billion in the first quarter
- On the earnings front, the first half of 2017 has been rock solid. Looking at Q2 as a whole, total earnings are on track to be up +9.4% on +5.1% higher revenues. This would follow +13.5% earnings growth on +7.1% revenue growth in Q1
- Near record low U.S. unemployment at 4.3% has been supporting cyclical consumer spending
- The U.S. remains in a 98-month expansion. Monthly labor market evidence is as follows: the U.S. created +209K jobs in July, +231K in June, +145 in May, +207K in April, +50K in March, +232K in February and +216K jobs in January.

Ask yourself this: *when weighing the positives versus the negatives, which one makes the stronger case?*

Bottom Line for Investors

In my view, the positives are still winning. That does not mean the negatives are irrelevant – they matter, but markets tend to be very resilient in the face of negative headwinds if the positive forces still point to growth, which in our opinion they do. Rising earnings, an upward sloping yield curve, high and rising leading economic indicators, and ample jobs at full employment tell us rising U.S. stock indexes remain the base case in the second half of 2017 and the early part of 2018. As such, we think investors should stick to a constructive view of stocks looking forward, and we can help you position your investment portfolio for what lies ahead.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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