Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY February 14, 2020

The #1 Threat to Long-Term Returns

One of the country's leading experts in behavioral finance is a Santa Clara University professor by the name of Dr. Meir Statman. Some readers may recognize Dr. Statman's name right off the bat. He has published numerous articles and books about investor psychology, and he has done extensive research on investment decision-making – detailing common errors, biases, blind spots, and so on. His recent article titled "The Mental Mistakes that Active Investors Make" caught my attention.[1]

I'll start with Dr. Statman's overarching conclusion: investors are their own worst enemies. Investors make decisions at just the wrong times. Emotional responses get in the way of sound judgment. Fundamental analysis and a disciplined investment approach are tossed out the window at the first sign of scary volatility. Overconfidence gives way to shunning or ignoring risk. The list goes on.

Why do investors continue making the same mistakes? But also, why do everyday investors continue trying to invest on their own, in an effort to beat the market?

Here are four mental mistakes that I think are among the biggest threats to achieving attractive long-term returns.

1. Practice Doesn't Make Perfect

With many skills in life, the more you practice, the better you get. If you've played the piano 1,000 times, you'll almost certainly be better than a person who has played piano ten or even 100 times.

Trading in the stock market is not like playing the piano. The piano is an instrument that doesn't change as you learn it, and it is not competing against you. The equity market, on the other hand, is constantly responding to different factors, economic data, earnings reports, interest rates, and so on. There is also fierce competition in the market – there is always someone on the other side of the trade, trying to be the winner.

Trading too often makes an investor vulnerable to making decisions on incomplete information, gut instincts, or emotional responses. For these reasons, I would even argue that a high trading frequency *reduces* your likelihood of beating the market over long stretches of time. Practice doesn't make perfect.

2. Measuring Performance Incorrectly, and Against the Wrong Benchmark

If an equity investor made a +15% return in 2019 and felt very confident with that result, my first question would be: *what was your benchmark in 2019?* If the benchmark was the S&P 500 index, then +15% is not a very good return. The S&P 500 was up +31.49% last year!

Going even further, investors often fall into the trap of measuring performance against a benchmark each year. But one good year is not necessarily the mark of a good investor. The best active investors outperform their benchmarks over long stretches of time, 10+ years or more.

There's also the matter of individual investors failing to correctly measure their performance in a given year. Dr. Statman references a study of members of the American Association of Individual Investors, where participants "overestimated their own investment returns by an average of 3.4% a year relative to their actual returns." This study illuminates a classic case of confirmation bias: investors want to believe they are superior managers, and therefore inflate returns to confirm their beliefs.

3. Overconfidence Clouds Judgment

Have you ever bought a stock that went way up, and felt like a genius afterward? Don't worry, that's part of every investor's story at some point in their lives. The question is, are you able to check yourself in those situations, to avoid associating a few good trades with being a brilliant investor?

Overconfidence tends to lead to more trading, which as I mentioned earlier, is a recipe for underperformance, in my view. Overconfidence also causes investors to shun or outright ignore risk, since 'gut instinct' outweighs fundamental research or a disciplined investment process. Too much confidence in the investment process can create blind spots.

4. Faulty Strategies with Limited Information

Self-directed investors often process decisions by only using information that is already in their minds, or with information heard or read on the news. But that means making decisions on information that is incomplete or already priced into the market – or both. Similarly, investors often flock to stocks that are garnering a lot of attention in the media, a bad strategy that needs no explanation in my view.

Dr. Statman uses the "52-week" strategy as an example of an unproven method that many investors use, i.e., buying or selling a stock based on whether it is at the low end or the high end of a 52-week average price. The problem is, stocks are not beholden to these 52-week channels – there is nothing stopping them from shooting through a 52-week high or plunging much further below a 52-week low. Investors are trading faulty strategies with limited information.

Bottom Line for Investors

A Fidelity survey of amateur investors – when asked why they trade on their own – found that over 50% did it for "the thrill of the hunt," or because they enjoyed the challenge and enjoyed sharing news with friends and family.[2] But when asked if self-directed investors' goal in trading is to "safeguard retirement," the affirmative responses go way down. Think about that for a moment.

Our aim here at Zacks Investment Management is applying our disciplined, proprietary, repeatable, and notable investment decision-making process to deliver attractive long-term results to our clients. We strive to strip emotion out of our process completely, account for all of the biases above, avoid them at all costs, and focus on the hard data. That's why many of our strategies are top-ranked by Morningstar,4 why our focus is on delivering attractive long-term results. In other words, we're all seeking to "safeguard retirement," and no "thrill of the hunt."

ABOUT MITCH ZACKS

Mitch is the CEO & Senior 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.

[1] The Wall Street Journal, February 9, 2020. https://www.wsj.com/articles/the-mental-mistakes-that-active-investors-make-11581304440?mod=hp_listb_pos1&mod=article_inline

[2] The Wall Street Journal, February 9, 2020. https://www.wsj.com/articles/the-mental-mistakes-that-active-investors-make-11581304440?mod=hp_listb_pos1&mod=article_inline

IN FOCUS THIS WEEK

- Americans have reached a new record for credit card debt
- Inside the Trump Administration's $4.8 trillion budget plan
- When will China return to normal economic activity?

Too Much Bad Debt

Consumer spending in the US has driven the economy – and arguably the stock market – to new heights. Consistent and strong employment gains over the last several years plus modest, but still positive, wage increases have boosted consumer confidence. But there's a problem with all this spending – a lot of it is going on high interest credit cards. Americans now have almost $1 trillion in credit card debt, which marks a new record. When it comes to credit card debt, nominal figures matter less than whether or not people are behind on payments. As GDP and wealth grow, we would expect credit card and other types of debt to grow as well. But in the current environment, the percentage of people far behind on their credit card payments is increasing. According to the Federal Reserve Bank of New York, the percentage of credit card debt that was overdue by 90 days or more (making it delinquent), rose to its highest level in 8 years.[1]

Highlights from the Trump Administration's $4.8 Trillion Budget Plan

The Trump administration's $4.8 trillion budget was released this week. The plan called for an increase of 0.3% in defense spending in 2021, to $740.5 billion, while lowering nondefense spending by 5% to $590 billion for the same year. Picking apart the plan a bit further, NASA would get a 12% boost in an effort to put astronauts back on the moon by 2024, the Department of Veterans Affairs would see a 13% increase in outlays, the National Nuclear Security Administration with a +19% uptick, and the Department of Homeland Security would get a 3% bump. On the other side of the equation – spending cuts – the Environmental Protection Agency (EPA) would lose over a quarter of its funding and programs like Medicaid and food stamps would see cuts in future years. 3 Like just about every budget plan before it, the plan as outlined has a very low likelihood of actually becoming law, particularly with the House of Representatives controlled by Democrats. In all likelihood, Congress will pass temporary spending measures for the balance of the year to move past the election, and take up the larger budget questions in 2021.[2]

When Will China Return to Normal Economic Activity?

Reports this week made it appear as though confirmed coronavirus cases were potentially plateauing, but then news reports Thursday cited 15,000 new cases (perhaps because of a rollout of a new way of testing for infection). Corporations have largely halted production in China and retail stores remain closed in large numbers across the country. The quarantines have led to a ghost town-like environment across the country, with the economic dynamism of production and consumption largely muted. The ongoing impact of the coronavirus has led many to forget that China has already been dealing with the pressure of lower global trade as a result of the trade war with the US – global trade fell -1% in 2019, which rarely happens outside of recessions. On top of all that, China has rising inflation levels on par with jumps not seen in nearly a decade, with the consumer price index jumping 5.4%.[3] We have written before that the crisis in China is likely to get worse before it gets better, and it appears the world's second largest economy remains decisively in the "getting worse" phase. We may not see a return to normal economic conditions until the second half of the year, in our view.

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[1] The Wall Street Journal, February 11, 2020. https://www.wsj.com/articles/credit-card-debt-in-u-s-rises-to-record-930-billion-11581442140

[2] The Wall Street Journal, February 10, 2020. https://www.wsj.com/articles/trump-proposes-4-8-trillion-budget-with-cuts-to-safety-nets-11581356145?mod=djem10point

[3] The Wall Street Journal, February 9, 2020. https://www.wsj.com/articles/u-s-china-trade-war-reshaped-global-commerce-11581244201?mod=djem10point

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns, which will be reduced by fees and expenses.

The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large-company common stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor. An investor cannot invest directly in an index.

Returns for each strategy and the corresponding Morningstar Universe reflect the annualized returns for the periods indicated. The Morningstar Universes used for comparative analysis are constructed by Morningstar (median performance) and data is provided to Zacks by Zephyr Style Advisor. The percentile ranking for each Zacks Strategy is based on the gross comparison for Zacks Strategies vs. the indicated universe rounded up to the nearest whole percentile. Other managers included in universe by Morningstar may exhibit style drift when compared to Zacks Investment Management portfolio. Neither Zacks Investment Management nor Zacks Investment Research has any affiliation with Morningstar. Neither Zacks Investment Management nor Zacks Investment Research had any influence of the process Morningstar used to determine this ranking.