

Do Emotions Matter?

Three months ago, we compared historical earnings, dividends and book value to subsequent stock market performance. This is the “knowledge” part of our motto, but the “discipline” is there because of our belief that controlling emotions plays a key role in investing success, perhaps even more than knowledge or logic.

Unfortunately, most humans are not emotionally wired in a way that makes for good natural investors. We tend to believe the future will be the same as the recent past. After important stock market bottoms, we believe it is too early to buy. When the market goes up at first, we believe it is too late to buy. As the rise continues, however, we get more confident, investing in the belief that the market can only go up. When the market exceeds normal reasonable valuation measures, we invent reasons why “this time it’s different” to justify our previous purchases.

With apologies to the generation that came of age in the 1960’s, the rule for successful investing is “If it feels good, don’t do it.”

Bull market tops are periods of maximum investor enthusiasm -- everyone is fully invested and nobody has any additional buying power. In a bear market, our emotions are a mirror image. At first, we believe it’s too early to sell, then it’s too late, and so on. Bear market bottoms are periods of maximum investor despair. Everyone has sold their shares and their (remaining) wealth represents potential buying power in the bull market that follows.

This is the fundamental paradox of investing -- often what “feels” like the best thing to do is the wrong thing to do. Our need to be accepted and connect with others makes us gratified when they agree with us and nervous when they don’t. As suggested above, this tends to lead us astray in investing. We are too greedy when the market is expensive and too fearful when the market is cheap. With apologies to the generation that came of age in the 1960’s, the rule for successful investing is “If it feels good, don’t do it.”

There are several recent illustrations of the havoc emotions wreak on investing. In *The Wall Street Journal* reprint we sent you last month, 20th Century Mutual Funds reported that investors in their Ultra Fund have done worse than the fund itself, because they tend to buy at high prices and sell at low prices. A recent *Forbes* column described an academic study comparing no-load funds to load funds going back to the early 1960s. No-load *funds* performed better than load funds due to lower expenses, but no-load fund *investors* did worse because it was easier for them to switch in and out of the market, which they did unsuccessfully. Another mutual fund family recently analyzed their largest fund,

one of the top performing funds of the past 15 years. In the biggest bull market this century, in one of the best funds, more investors lost money than made money due to buying high and selling low. The adage is to “buy low and sell high,” but, emotionally, it can temporarily be more satisfying to buy high and sell low when you are moving in the same direction as the crowd.

In addition, a well designed mutual fund portfolio does not provide exciting cocktail party chatter when somebody smugly tells you about Digital Datahack, their new stock, going up 500 percent. Brokers sell individual stocks on the basis of a “story” with the punch line that the stock is “the next Microsoft.” The story creates an emotional attachment that is destructive when the facts change (if they were correct in the first place). Many brokerage accounts wind up as a jumble of ideas that bear no relation to the investor’s situation. This is one of the reasons Sigma focuses on mutual funds -- since there is no “story,” the lack of emotional attachment makes it easier to act when action is appropriate.

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Eighty percent of the money in equity mutual funds has been invested since the last significant correction in 1990. Extrapolating the recent past, the financial press and academia are proclaiming the benefits of investing “for the long run.” People have responded by becoming more aggressive in their investment choices, far more aggressive than when the market was significantly lower. How will they react when they first encounter a bear market? Will they become disgusted with their investments and sell? “Investing for the long run” is excellent advice, but where were its recent proponents in 1974, when the Dow Jones Industrial Average was at 580, or in 1982 with the Dow at 790? At those important market bottoms, “everyone” was proclaiming the benefits of gold, money funds and tax shelters.

You can have the best diet plan in the world, but if you lack the discipline to stay on it, it’s worthless. The same is true of investing “for the long run” -- if you can’t emotionally handle what a bear market will do to your portfolio, your plan does you no good. A plan that depends on the market never going down is no plan at all. Your objective should be to develop a rational investment plan that you can actually live with for the long run, regardless of recent market behavior. If you would like help in developing such a plan and sticking with it in good times and bad, call us.