

Human, All Too Human

“Why can’t somebody give us a list of things that everybody thinks and nobody says, and another list of things that everybody says and nobody thinks?” – Oliver Wendell Holmes

Last month we extended this musing of Justice Holmes from thinking to talking to action and discussed a few things (rotating tires, flossing, rebalancing your investment portfolio) that everyone claims they do, but few people actually do. We risked lowering your self-esteem by quizzing you about the equity percentage of your portfolio at the market high in 2007 versus the same percentage at the market low in 2009. This month, we will restore your self-esteem by demonstrating that almost nobody else is doing the right thing either.

According to Ned Davis Research, using data from the Federal Reserve Board, at the end of 2009 stocks accounted for 34.2 percent of household financial assets. 37 years previous, at the end of 1972 as the Dow Jones Industrial Average hit all-time highs, closing above 1,000 for the first time, stocks also accounted for 34.2 percent of household financial assets. “Aha!” you might say, “Since the Dow Industrials were 10 times higher in 2009 than in 1972, isn’t that evidence that investors, as a group, *are* rebalancing their portfolios?” Alas, the answer is no, as is evident following the historical course of that statistic. In 1972, the U.S. stock market was just starting a devastating bear market, hitting a low in late 1974. Despite the market going up afterwards, albeit in a choppy and frustrating manner, investors increasingly were disgusted and dismayed for a full 10 years after the high. The household equity percentage bottomed at just over 13 percent in 1982, just as stocks were at record-low valuations relative to earnings and were about to embark upon one of the greatest extended bull markets in history.

The flip side of this psychology came in the late 1990s. After the market had gone up for a decade, investors began to get excited about stocks again, accelerating their equity purchases while stocks became more and more expensive. As the Dow reached an all time high in the first quarter of 2000, and a record-high valuation relative to earnings, the equity percentage of household portfolios also hit an all-time high at 54.2 percent. As we now know a decade later, the market did not reward this ebullience.

The household propensity for equities hit its most recent bottom in March 2009, right at the market low after the financial crisis. This wrong-way investment timing by the public is a facsimile of its behavior in the previous secular cycle. In the 1966-1982 secular bear market, it took investors 13 and one-half years to travel from the heights of enthusiasm to the depths of despair. A similar passage of time from the 2000 peak would take us to the fall of 2013, indicating that disgust with the stock market could get worse for another three and one-half years. Of course, history rarely repeats exactly, so there certainly is no assurance that this timeframe will hold. (We have referred to the household equity percentage over the years in these newsletters – if you would like a copy of the chart, please send a request to info@sigmainvestment.com.)

*Learn by experience –
preferably that of other people.*

We can see a similar, depressing dynamic looking at mutual fund flows from the Investment Company Institute. March 2010 was the sixteenth straight month in which more money went into bond funds (or less money flowed out) than stock funds, and the 46th month out of 47. It was not always thus – from late 1992 until early 2001, net stock fund flows exceeded net bond fund flows in 98 out of 100 months. When one looks at a chart of monthly stock mutual fund net inflows going back to 1980, there is a broad, long-term increase of inflows (interrupted for a couple of years after the 1987 crash) until the all-time high inflow in February 2000, right at the stock market peak. Since then, there has been a broad, if choppy, long-term decrease in flows until now. Recently, there have also been huge outflows from money funds and huge inflows into bond funds, leading market observers to wonder if we are seeing a “bond bubble.” This seems odd to us, since the most frequent fear we hear from prospects is of a leap upward in inflation, given the expansionary fiscal and monetary policy sparked by the financial crisis. If you really fear inflation, bonds would not be your investment of choice.

We believe the recent inflows into bond funds reflect the logic that you cannot beat something with nothing. People are afraid of stocks, and they realize they are earning approximately nothing on cash. Between stocks, bonds and cash, bonds win just by the process of elimination. “Bubbles” describe people falling in love with an asset beyond the point of rationality. We do not see a lot of love for bonds, just distaste for anything else.

As all this depressing history shows, people naturally tend to do the wrong thing in investing – they may talk a good game, but they do not walk the talk. This is natural, because the natural thing to do, the thing that most people actually do, is the wrong thing to do. It is wrong to have the peak percentage in equities, and the highest flows into equity funds, at market tops when stocks are expensive. It is wrong to have the lowest percentage in equities, and the biggest outflows from equity funds, at market bottoms when stocks are cheap. However, those wrong moves are exactly what we see in the household balance sheet and mutual fund flow data.

Left to their own devices, investors will be fearful at market bottoms and rash at market tops. This is especially true given the volatility we have seen in the past several years. How can you buy stocks after they have caused you pain? How can you sell stocks after they wonderfully have enhanced your portfolio’s value? Emotions harm returns, and the successful investor or adviser must overcome the natural, common response. Talk is cheap, but action is hard. Consistently doing something counter to human nature takes training, discipline and experience.