Client's Corner

The Natural, Normal Human Impulse That Dooms Investment Success

> **I think it's fair to say that the fear generated by one or more declines has prompted many (if not most) investors to flee even their highest-quality equity investments at some point during their investing lifetimes.**

I BEGIN WITH A SIMPLE PREMISE, TO WIT: LONG-TERM EQUITY investing is overwhelmingly an issue of temperament. Please hold that thought for just a moment while I present two seemingly contradictory statistical facts. We'll get back to the issue of temperament immediately thereafter.

(1) The Standard & Poor's 500-Stock Index came into the year 1950 at 17. It's around 5,200 as I write. Astonishing as that is—or certainly ought to be—it materially understates mainstream equities' accomplishment, in that it ignores dividends. With dividends reinvested, and taxes paid from another source, $1,000 invested directly in the Index in January 1950 (which I freely acknowledge you couldn't do in those days) would have grown to about $2.9 million today. You didn't ask, but the average annual compound rate of total return in this period was over 11%.

(2) During this same period the Index experienced an average decline of close to one third, on an average of every five years. (The most recent of these was a quite memorable 25% decline in 10 months in 2022.)

This may be a bit of an oversimplification, but: in a very real sense, I believe it's ***which one of those phenomena we respond to most strongly*** which will determine our long-term, real-life investment results. That is, which one—the long-term advance or the periodic declines—we allow to drive our overall investment strategy.

Intellectually, rationally: this may appear to be something of a no-brainer. Simply stated, even from this fragmentary evidence, one can deduce that the long-term growth of both values and dividends of mainstream equities has completely overwhelmed the frequent, often significant but ***so far*** always temporary declines. (Please be reminded that **past performance is no guarantee of future results.**)

But temperamentally, I think it's fair to say that the fear generated by one or more of those declines has prompted many (if not most) investors to flee even their highest-quality equity investments at some point during their investing lifetimes. What explains this?

I believe the culprit to be one powerful, basic human instinct that is natural, normal—and completely destructive of long-term equity investing success. What makes this instinct so mysterious is that it's the diametric opposite of the way we behave in every (repeat: every) other aspect of our economic lives.

In the totality of our lives ***other than investing,*** we are increasingly attracted to the things we need or want ***the more their prices decline.*** We perceive lower prices as offering increased value. The converse is equally true: as the price of a good rises, we seek ways to consume less of it, to find cheaper substitutes, or to pass it by altogether. Rising prices signal diminishing value, and they repel us.

Now consider the curious case of our long-term equity investments. Again, let's use the example of the S&P 500—composed as it is of five hundred of the largest, most profitable, most soundly financed and most innovative American companies.

These are not just names we recognize: many may be companies whose products and services we use regularly—perhaps as often as every day in some instances. And it's not too much to say that we're relying on those businesses to increase our capital as well as our dividend income throughout what may turn out to be a three-decade, two-person retirement. As indicated above, taken together they have an exemplary record of producing those outcomes over time.

Then one of the aforementioned significant market declines sets in—almost always in reaction to some genuinely negative economic and/or financial development—a real crisis, if you will. The virtual cessation of the global credit function in 2008 is one extreme example; the massive lockdown of the global economy in COVID is another. Share prices fall suddenly and dramatically—and for very good reason.

But instead of looking to step up our purchases of the marked-down shares—reasoning correctly that as prices decline, the underlying long-term value of superior companies must be rising—our natural, normal and completely upside-down human nature demands that we sell before this "unprecedented" crisis engulfs us all. ("This time it's different.")

Then let the crisis pass (as it always has), and let share prices and dividends resume their gradual upward march (as they always have). And suddenly, the flip side of that very same quirk of human nature has us buying equities with increased fervor ***the higher and higher prices rise.*** And not just ***some*** equities: we are driven to chase those equities ***which have already gone up the most,*** rather than shopping more selectively among sectors which haven't moved quite yet. This may sound like a vicious cycle, but it's actually a downward spiral.

And it explains why so many investors go through life not just underperforming the market, but underperforming ***their own investments*** through ill-timed buying and selling. People can't help themselves: it's just human nature. And human nature is immutable. Accepting this, one suddenly realizes what one's wealth manager/advisor is really there for—to help us grasp that successful long-term investing actually demands that we go against our own most basic instincts.

Let me suggest to you that a serious examination of this ceaseless tension—human nature ***versus*** successful investing—is a conversation you'd be well advised to have with your wealth manager. You may be surprised to discover how eager he/she will be to have it with you.

Sources: S&P 500 prices: Standard & Poor's, Yahoo Finance. Compound return: DQYDJ Return Calculator (data from Robert Shiller). Incidence of market declines since 1950: Yardeni Research.