staying CALM

financial fitness

By Erik Ford

We have lived through two-plus years of remarkably interesting times, and now, as of the time of this writing, we have a war in Ukraine and record-setting inflation at home. Interest rates are rising, and there is much uncertainty as to what is next. It is exactly in times like these when it is hardest to keep calm that it is critical that we do so. Our human tendencies conspire against us, and we may make investment decisions that harm us eventually. Volatility in the financial markets is never easy to live through, but understanding the long-run implications of these decisions and what is in our nature that drives them can make us better investors.

First, the markets have always been volatile, and returns vary much more over shorter time periods than in the long run. As investors, our objective should be to capture that long-run return and not create our own obstacles to success. In the last 120 years, the Dow Jones Industrial Average has averaged a 5% or more decline three times a year. It has averaged a 10% or more decline at least once a year and a 15% or more decline about once every two years. Even larger declines of 20% or more occur about once every three and a half years, certainly not an infrequent occurrence. Recoveries from these declines range from 47 days (about one and a half months) on average for the 5% declines to 338 days (about 11 months) for the 20% plus declines, but importantly, recoveries do occur, and decisions made in the throes of these declines can permanently reduce long-term performance. The reasons for these declines vary widely from economic to government policy to even war, or sometimes they occur without discernable explanation, but they are a part of the workings of financial markets.

Reacting to short-term market volatility can inflict a negative impact on your investments that may be difficult or impossible from which to completely recover. Volatility frequently goes in both directions, and missing out on those positive days because of your reaction to a market sell-off can be costly. An investor investing $10,000 in the S&P index on January 1, 1980, who remained invested, would have had $697,421 by March 31, 2020. If that same investor had missed the five best days over that period, they would have had $432,411, a 38% decline in value for just missing five days! Missing the best 10 days reduces the results by 55%, and missing the best 30 days reduces the results by a whopping 83%. These results can make the difference between a satisfying retirement and a stressful or delayed retirement.

Understanding what makes us do these things can go a long way toward helping us avoid them. I will focus on three behavior biases that factor in, although there are more to be aware of. One of these biases is recency bias. Recency bias is our tendency to expect what happened recently to continue happening. In financial markets, that is our tendency to expect down days to continue following one or two big down days. Of course, sometimes they do come in a string of down days, but it is not unusual for a big up day to follow a big down day, and if you sold into the decline, you missed one of those crucial up days.

A second bias that factors in is Loss Aversion bias. No one likes to lose, especially money, but reacting to a decline in value that may not be a permanent condition only makes that unwanted loss permanent, resulting in exactly what the investor wanted to avoid. Our recency bias tells us the losses will continue, and the loss aversion bias tells us that will be painful, so we run.

Anchoring bias is what causes us to rely too heavily on the first piece of information we see or are given and discount additional information that may provide offsetting evidence. We look at added information through the blinders of the conclusion we drew from the earlier data, which clouds our objectivity for future decisions.

Overcoming our tendencies to react in the short term to events that are much less impactful in the long run is difficult and takes a certain level of discipline (and occasionally a strong stomach). However, as the past demonstrates, it is important to recognize and check our biases in order to increase our chances of success.

Erik Ford is the owner of Ford Wealth Management LLC in Glen Ellyn, IL. He is a CFP® certificate holder as well as an Accredited Investment Fiduciary®.

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