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Avoid the Five Bear Market Mistakes

By: William Schneider, Managing Director

Bear markets bring out the worst in investors because our natural “fight or flight” emotions leave us almost hardwired to lose money. In fact, an old Wall Street adage is “A bear market is when money returns to its rightful owners” – those who are psychologically prepared to buy when everyone else is selling.

Behavioral Finance is the study of the intersection of psychology and finance; it is the antithesis of Modern Portfolio Theory (MPT). MPT states that investors act rationally; they try to avoid risk and maximize return, incorporating new information as it becomes available. Behavioral Finance states that not only are investors *irrational*, they are irrational in predictable ways. The culprit is something called “heuristics” – mental shortcuts that let us deal with complex situations in simplified ways. Both theories have some explanatory power, but Behavioral Finance seems particularly good at explaining investor responses to market extremes.

So what are the big five mistakes?

1. **“This time is different.”** Of course the exact circumstances of each market decline vary, but human psychology is a constant. Therefore, the cycle of bull and bear markets is also a constant. In bear markets, prices fall to a level that discounts current economic troubles and then usually overshoot. People extrapolate the current conditions into perpetuity and, of course, there is no shortage of “experts” who support any position. In 1981, Newsweek declared “stocks are dead!” Now we’re hearing that “buy and hold is dead!” Eventually, assets become so cheap that knowledgeable investors start scooping them up. The thought that “this time is different” is so dangerous because it provides the rationalization for the non-productive behaviors described below. A variant is “*This is like the great depression.*” Same result.
2. **Mental Trigger Point.** This is a version of the heuristic called “*anchoring*”. The investment committee might say something like, “we’ve gone from \$100 to \$78 million, but we can’t let the fund fall below \$75 million. If we get to that level we have to change the allocation so we don’t take more losses (e.g. go to cash and bonds). In some situations that may make sense, but in most cases it is an arbitrary number. The anchored number may come from an earlier balance... “When I joined the committee, we were at \$75 million.” Or, it may represent a previous maximum theoretical decline (25% below \$100 million). In this example, the move from \$78 to \$75 million represents a drop of less than 4% from the current level. The markets have a nasty habit of bottoming out just below the trigger points of most investors... when the last sellers have sold.

3. **“It’s not market timing, but…”** Committees may want to wait to rebalance or commit new funds until: “after the inauguration”...“the volatility comes down”... “we see what’s happening with capital gains” etc. This is a version of the heuristic called “*snake bitten*”. The investor has experienced the downside of risk taking activity, but can’t take the action necessary to profit from the ensuing rebound. The problem is that people regret a loss more than they regret missing an equal upside opportunity. They abandon the well-thought-out strategies adapted in less stressful times.
4. **Magical Thinking** – Committees want to believe that losses could have been avoided. Self promoters and outright frauds take advantage of the situation. You may have heard radio ads proclaiming “our investors haven’t lost a penny in the recent market declines; we’ll even give you a guaranteed 10% return” (likely a high-commission insurance product with a long lock-up period, substantial withdrawal penalties, and a guaranteed annual rate well below 5%). Bernie Madoff kept his Ponzi scheme going for years because people wanted to believe that they could earn 13% per year with no volatility – a \$50 billion free lunch.
5. **Herd Mentality** – People are social animals; we tend to blindly follow the majority position or “loudest” high conviction idea. In a bear market a “negative feedback loop” reinforces selling. The fall in home prices is a perfect example. Foreclosures lead to forced selling which leads to falling prices, leading to negative equity, leading to defaults, leading to more foreclosures. In the financial system “runs on the bank” brought down Bear Sterns and Lehman Brothers and forced the sale of Merrill Lynch and Goldman Sachs. Eventually, however, the selling dries up. “The cure for low prices is low prices.” Certain asset classes become so cheap that a few brave souls start buying and thus begins the next bull cycle.

So, how can you avoid the big five?

- **Turn off the TV** – this will reduce your anxiety level and keep you from “group think”.
- **Stick to your game plan** – especially when it’s emotionally difficult.
- **Find knowledgeable advisors** – well grounded in investment best practices.
- **Avoid unbelievable claims** – “I got everyone out in November of ’07” - Oh yeah? Give me 10 references.
- **Make investment decisions based on the current situation** – e.g. you no longer have \$100 million; what is the best investment strategy to optimize results for the current \$75 million balance?)

It’s easy to be procedurally prudent during good markets. Follow a prudent game plan even when the going gets rough.