You're Wired to Destroy Your Wealth

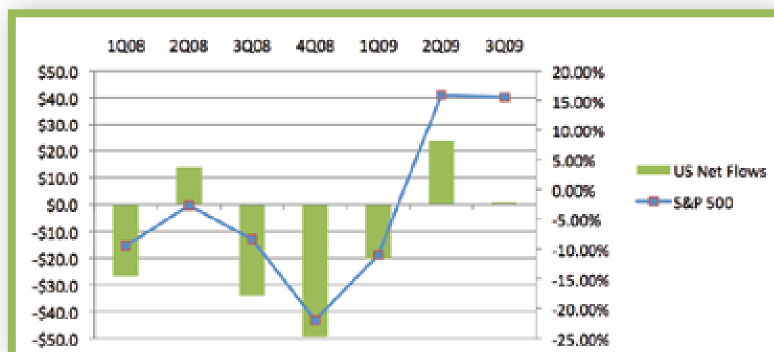
By Keith McKenzie

In Garrison Keillor's fictional Lake Wobegon, "all the women are strong, all the men are good looking, and all the children are above average." While humorous, Keillor is actually describing a real-life psychological condition known as the "superiority bias" – in English, the tendency to overestimate one's own positive abilities relative to others.

Overestimating skill, underestimating risks, over-reacting to random events, seeing trends where none exist and applying hindsight bias are all behaviors that can affect investors. These types of cognitive biases work to investors' disadvantage as they try to preserve and grow their wealth. Indeed, numerous behavioral economists have proven that investors will predictably and repeatedly make irrational decisions regarding their money. Understanding why investors make bad decisions can often help them (and their advisors) break this cycle and make better, more informed decisions.

An example of the actual effects of investor behavior on investment performance comes from a recent study performed by Dalbar, a leading financial services market research firm. For the 20-year period from 1990 through 2009, the broad U.S. stock market (as represented by the S&P 500 index) had an annualized return of 8.20%, while the "average" equity investor only achieved a 3.17% annualized return during that same time period. What explains this gap? Put simply, bad investor decision-making, driven in large part by mental and emotional hard-wiring. During rising markets, investors become over-confident and greedy, piling into whatever asset class has recently outperformed (think technology stocks in the late 1990s), leaving them overexposed to the inevitable downturn, while in falling markets fear and risk aversion cause those same investors to flee from whatever has just done poorly (think all asset classes other than U.S. Treasuries in 2008). This leaves them unable to participate in the equally inevitable recovery. This type of "buy high, sell low" psychology does enormous, and often irreparable, damage, to a portfolio.

Don't believe it? The following chart tracks money flows into and out of U.S. equities during the most recent bear market:



Source: Morningstar (Estimated Net Flows Open End Ex MM and FOF) and Delphi Private Advisors.

Predictably, investors take money out of the stock market during down quarters and only return after the market recovers. This behavior causes investors to capture much of the downside, while missing much of the upside, significantly reducing their long-term returns. However, investors are not acting alone.

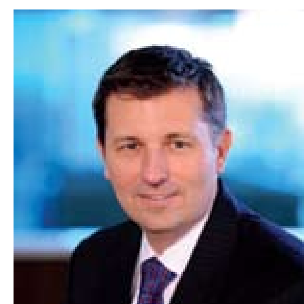
WALL STREET IS MORE THAN HAPPY TO HELP

Wall Street manufactures and distributes financial products that reflect the mood of the "times," enabling investors to quickly and easily satisfy their need to act against their own best interests. When markets are up, products are rolled out that tout high returns and fast growth, while ignoring risk. As markets turn down, the messaging changes to emphasize safety and capital preservation. While the actual path of the market may be volatile and, in the short run, unpredictable, what is predictable is that the financial services industry will be ready to play upon investors' fear and greed to sell its goods and services.

THE REAL VALUE OF AN ADVISOR

A true advisor understands their clients and helps them steer through both market cycles and their own emotions. In addition, an advisor that receives no commissions from Wall Street can act without conflict during emotional periods. Just because you're hard wired to destroy your wealth, doesn't mean you need to!

KEITH MCKENZIE:
Partner, Delphi Private Advisors
Delphi is an independent Registered Investment Advisor providing investment planning and management for wealthy families.



keith@delphiprivate.com
858.222.8095