Investors Behaving Badly

Why investors make bad investment decisions — a study of investor reactions to risk and return in the context of time

WRITTEN BY:

Donald Nesbitt, CFA
Chief Investment Officer - Ziegler Equity Strategies, Senior Portfolio Manager

What is Behavioral Finance?

Intuition by definition, is the action in which the mind relies upon pattern recognition to provide it with solutions for problems and decision making. Even when patterns are not clear, intuition can be useful in making blunt decisions. For example, early man used his sense of fight or flight to aid in his survival. Modern man is a product of his ancestors' successful adoption of these intuitive responses: those early humans that did not learn to run and find cover when they heard the growl of a saber-tooth tiger were unable to contribute to the gene pool.

Intuition works well in solving relatively simple problems where a direct cause and effect can be readily identified and associated with a recurring outcome. However, intuitive responses often fail when applied to more complex, dynamic challenges like investing. Investing encompasses a multitude of factors interacting to produce a variety of potential outcomes. These limitations have encouraged the development of behavioral finance.

Behavioral finance integrates classical economics and finance with the study of human psychology and decision-making to determine how investors systematically make errors in judgment, or "mental mistakes" in their investment decisions. Research generated by the field of behavioral finance provides numerous theories that describe how investors' actions can produce poor investment decisions. These ideas are captured by expressive labels such as "anchoring," "framing," and "mental accounting," all developed to explain unique behavioral patterns. These concepts can essentially be categorized into one of two response sets: investors' "over" or "under" reaction to the information affecting their investment decisions. By analyzing investors' responses in the context of "over" and "under" reaction, behavioral finance provides a tool that seeks to identify potential shortcomings in risk and reward management decisions associated with investing.

Over-reaction means investors place too much weight on past information in forming their expectations regarding future events. Under-reaction means investors give too little weight to new information. Over- and under-reaction appear in different forms and produce distinctly separate results depending upon the circumstance and time frame in which they are measured.

Investors' Behavior Differs Toward Risk and Reward and is Influenced by Time

Investors react differently to risk and reward depending upon the circumstances and context of time in which investment choices are presented. Human psychology is more predisposed toward avoiding risk than it is to seeking reward. This asymmetrical relationship is described by a concept referred to as "prospect theory," which states that, for most investors, the pain

70 West Madison Street
Suite 2400
Chicago, Illinois 60602

Phone: (312) 368-1442

Web: zieglercap.com

associated with losses exceeds the pleasure of gains. This idea is expressed in economics and finance through the concept of "risk aversion," which proposes that investors want to avoid risk unless adequately compensated for it.

For example, if two investments have the same expected return, the one with lower risk will be preferred. A riskier investment has to have a higher expected return in order to provide an incentive for a risk-averse investor to select it. Interestingly, this intuitive behavior accurately reflects the asymmetrical mathematical effects of returns, which can be described by the following simple illustration: if an investor experiences a 50% loss on his original principal, he will require a 100% return on his remaining balance in order to break even. From a risk-averse perspective, investors are well served by their instincts and intuition, which programs them to be fearful of losses and avoid the associated pain.

Intuition and instincts are often "reflective" in nature and allow humans to immediately react to the conditions at hand. These behaviors are useful in "fight or flight" types of situations requiring an immediate and direct response, but these impulsive responses can set investors up to fail in situations that play out over longer time periods. Quick, reflexive decisions based upon intuitive judgment may be useful to the speculator and gambler, who tend to make quick decisions in short time-frames. However, successful investing requires maintaining and managing assets over longer time periods and various market environments. Unfortunately, during longer time frames our intuition often works against us.

Investors' Behavior Toward Risk Over Time

When viewing risk in the context of time, people tend to react strongly (often overreacting) when initially presented with a risky situation. The over-reaction is typically short-lived, however, and as time passes, people are sometimes inclined to become more complacent and under-react to potential risks as their fear of loss diminishes.

For example, property owners are very mindful of natural disasters and when they witness a crisis like a major hurricane or flood, they will typically call their insurance company to either buy adequate coverage or upgrade their existing policy. Some may even overreact and purchase unnecessary amounts of insurance coverage. As time passes without a catastrophic occurrence, people tend to grow more complacent and often ignore or put off spending on insurance policies. As more time passes without the incurrence of a loss, the premium may even be viewed as an aggravating expense, with investors losing sight of the risk it was designed to mitigate.

As more time goes by, people may be lulled into a false sense of security and in effect, under-react to their risk exposure. An illustration of this behavior surfaced in the credit markets during the "financial crisis." After experiencing a relatively long period of solid growth in the economy and housing markets, lenders had grown complacent to the risk of potential default by their borrowers. As a result, they did not adequately price their loans to reflect that risk. With the occurrence of the sub-prime "crisis," investors were suddenly made aware of their negligent attitude toward risk. By the time the drama fully played out, investors' overreaction resulted in many solid quality investments being tarnished along with the poorly-conceived instruments.

Investors' Behavior Toward Reward is Influenced by Time

The passing of time affects how investors view performance. People tend to overreact to performance trends that are in place over long periods of time, and they are slow to accept and under-react to new information suggesting the current trend cannot be maintained.

When forming expectations of future returns, investors often look to the past for guidance in their decision-making, seeking patterns that make them comfortable. As a result, they may look for and invest in companies that have provided strong performance trends in the past, their confidence being reinforced by the longevity and above-average performance of the past trend. Ironically, they will likely buy high.

By relying too heavily upon past results in the formation of their decisions, investors can attach too

much significance to past performance and overreact to past results. A product of overreaction is investors' tendency to project past trends into the future, ignoring the fundamentals that support an asset's price.

Market pundits and experts love to point out how a favored company's sales, earnings, margins, and more have grown at some phenomenal pace in the past. These seductive stories often lead investors to ignore economic and mathematic fundamentals.

No company can continue to compound its sales or earnings growth at an excessive rate. For example, if a company with a market capitalization of $100 million were to double in size every year, the value of its stock would exceed $13 trillion after 18 years, an amount that is roughly equivalent in size to the entire U.S. stock market. This over-projection produces what we call "glamour" stocks — stocks that have had their prices bid up so high, they are "priced for perfection" and tend to produce disappointing future performance.

Can Investors Modify Their Behavior?

How can investors overcome the behavioral biases that appear to have been hardwired into their psyche and produce a predisposition toward making poor investment decisions? First, investors need to be aware of risk and reward biases. Second, investors need to refrain from acting impetuously in their investment decisions.

Well thought-out investment strategies are the product of a systematic investment policy that lays out an investor's return requirements, risk tolerance, time horizon, and other special considerations. By establishing these objectives and defining them at the outset, investors can help manage the investment process in a more orderly, controlled manner and avoid many of the behavioral pitfalls that cause improper over- or under-reaction to market events.

Ziegler Capital's Periodic Table of S&P 500 Sector Performance provides some insight into how investor behavior can drive performance across sectors of the equity market. Energy stocks were big winners in the three years leading up to 2008, when oil prices peaked at $145 a barrel in early July among amid forecasts by "experts" of $200 a barrel oil and declarations that we would never again see oil below $100 a barrel. By the end of 2008, the price of oil had dropped below $34 a barrel and it was several years before oil traded above $100 a barrel. Oil traded in a range of $90 to $110 a barrel for several years until late 2014, when fundamentals drove the price down to $26 a barrel in early 2016. Once again, the pundits were talking of ongoing gluts and potential for oil prices to reach mid-teens or even single-digit levels. Oil prices have now recovered to the upper $40 range and energy sector stocks, which were the absolute worst performers in 2014 and 2015, are among the top year-to-date performers in the S&P 500 Index.

The top performing sectors in the S&P 500 Index for 2016 have been Telecommunication and Utilities, as investors have bought these stocks for their relatively high yields in this low interest rate environment. We recognize that low economic growth coupled with unconventionally easy monetary policy has produced a low return environment that has global investors scrambling to find yield, but we cannot help but worry that the market's current focus on yield may eventually come to a painful end.

Periodic Table: S&P 500 Sector Performance

This chart provides a detailed look at the S&P 500 Index's performance over the past decade, broken down by its 10 sectors.

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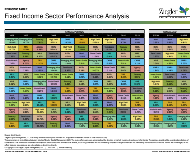

Periodic Table: Fixed Income Sector Performance

The chart provides a detailed look at Fixed Income performance over the past decade, broken down by 13 sectors.

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ZIEGLER CAPITAL MANAGEMENT, LLC

70 West Madison Street | Suite 2400 | Chicago, Illinois 60602
www.zieglercap.com

CONTACT US

(312) 368-1442
letters@zieglercap.com

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