American Portfolios Research Report: Investor Behavior Tools to Apply in the Current Market

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LEGENDARY INVESTOR BENJAMIN Graham once said, “The investor’s chief problem—and even his worst enemy—is likely to be himself.” Financial advisors have it even worse, needing to manage their own biases as well as those of their clients. The equity markets have been turned into a casino game once again with Reddit taking the place of the old AOL chat rooms of 1999. It is clear to us that fundamentals are not driving asset values and have not been for quite some time. GameStop (GME) is an extreme example of this. The purpose of this American Portfolios (AP) Research Report is to address events that took place in the last week of January 2021 regarding GME and other heavily-shorted stocks. We will do so briefly from a market perspective, but more so to discuss the topic of investor behavior and how we can use the various tools available to us to become better investors for our clients.

IN OUR VIEW …

The mind-blowing rally/short squeeze in a variety of stocks during the week of Jan. 25, 2021, will have a modest impact on the overall market, in our view. Year-to-date, the 100 stocks with the highest short interest are up 70 percent. Despite the huge rally in these stocks, the S&P 500 is close to flat for the year so far. We expect that hedge funds will reassess risks, which will drive rallies in a broader basket of out-of-favor stocks and industries. This has already begun, and we believe it will continue in the short term; however, it is unlikely to impact the broader markets. There could be an opportunity for astute value hunters, but the lesson from GME and others is that technical factors can quickly drive a stock well past fundamental value. How that particular stock shakes out in the short-term is anyone’s guess, but a quick look at GME’s financials will likely tell you that the long-term move is down in a huge way—which will ultimately decimate those who are chasing price momentum over fundamentals.

ASSESSING AND IMPROVING INVESTOR BEHAVIOR

This brings us to a conversation about investor behavior and how to assess and improve our own. Individual emotions and biases—such as fear, greed, herding and loss aversion—drive investment decisions that can impair retirement plans and other accumulation goals. It is our job to stop that from happening. We have survival mechanisms that have served us well throughout history; but they can, at times, be poorly suited for the investing world. Selling or flight (of fight or flight) at the first sign of market distress, buying what everyone else is buying and limiting investment exposure to home markets or the industry that the client participates in are just some examples of how biases can hurt investors or, more accurately, how investors can hurt themselves.

When we assess the recent market activity, two investor behavior shortfalls come to mind: herding and overconfidence. Herding occurs when a group of investors ignores their own information and instead only follows the decisions of other investors. Herding is a tough bias to correct. There are no great answers to solving this behavioral glitch. It is about emotional control and accepting that you may miss out on some gains. It’s also about being disciplined to a process and investment philosophy. The greatest investment philosophy in the world is worthless without the discipline to stick to it when things are going against you or when something else is looking more favorable. One could say, it is as good as having no philosophy at all. Herding or chasing price performance is also known as “the greater fools” theory. One behaves like a fool, hoping to find someone even more foolish—hardly a good game to play with money.

Overconfidence is also at play in the GME scenario, both by the short sellers who took oversized positions as well as those retail investors who piled into the stock at higher and higher prices. Overconfidence is a serious bias in the markets on any day. Many investors miscalculate the probability of good outcomes, focus too heavily on potential upside and fail to consider the potential downside. In the case of GME short sellers, they seemingly overlooked the technical aspects that could go against them in the short term while betting the company would go bankrupt in the long term, which may ultimately prove to be true. A good tool to use to help limit this behavioral mistake is to play the devil’s advocate. For example, spend as much time assessing what could go wrong and the price action associated with such an action as you would assessing the upside of a particular investment. A next step would be to have a plan in place should such negative events occur and outlining how you would react, whether that is by limiting losses based on price or percentage, or the breakdown of certain fundamentals. Decisions that are made in the moment, when an investment is already moving against you, become emotional and are often made without full information; therefore, it is best to have a plan set in advance.

Overconfidence also relates to the hot-hand fallacy. It is important to avoid complacency after good performance. When the market rallies day after day on the Federal Reserve (the Fed) or government support, it becomes very easy to coast. There is no doubt that many advisors and investors are doing a lot less research now with the markets near the highs than when the markets were under stress, because there is less pressure and everything appears easier. You must approach every investment decision with the same rigor and process, regardless of whether or not the wind is at your back.

Another tool that has value is in maintaining a trade journal. Regulators already require financial advisors to keep due diligence folders in order to deter impulsive decisions. If you cannot write down four to five sentences on why you want to own something, you should not be buying it. It also allows you to track all your decisions and learn from past mistakes. Having an investment council can accomplish the same goal, too.

SUMMING IT ALL UP

We have no control over the market; we can only control the research and decision-making process. We are trying to predict the future. We are going to be surprised by events that come out of nowhere. We are going to be shocked by the market’s responses to various events. We are going to make emotional and psychological mistakes. There is no avoiding it. However, if you craft a well-thought-out investment philosophy and maintain discipline in your research and decision-making process, you will be ahead of the game—and so will your clients.

You may have heard of some of these tools before, but there is a difference between knowing and applying them. I urge you to take a close look at these suggestions and figure out a way to weave them into your practice. Making money has been reasonably easy over the past 10 years. I believe we are heading into a cycle of higher volatility and larger economic and market swings than we have seen. Make sure you and your clients are prepared from an investor behavior standpoint to navigate those swings.

QUESTIONS AND COMMENTS

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Sources:

[1] FactSet Research

Disclosure:

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