



Financial Fables

If It Feels Right, Don't Do It!

In a 1998 speech, during the height of the dot-com bubble, Alan Greenspan said "...just as a bull stock market feels unending and secure as an economy and stock market move forward, so it can feel when markets contract that recovery is inconceivable. Both, of course, are wrong. But because of the difficulty imagining a turnabout when such emotions take hold, periods of euphoria or distress tend to feed on themselves."

This triumph of emotion over reason may actually be biological. Neuroscience tells us that the brain activity of a person experiencing financial gains is indistinguishable from the activity of someone high on cocaine and that the region of the brain that processes financial losses is the same region that processes mortal danger. Neurological research has also confirmed what Greenspan observed, we believe current circumstances will continue forever because our brains have seen a series of either gains or losses and have automatically and subconsciously accepted the notion that this current pattern will be repeated; when the pattern is broken our brains respond with alarm. But broken patterns are a common, and often necessary, part of the cycles we find in nature, history, science, and even in our own bodies.

Some cycles, like planetary orbits, are consistent and predictable, while others such as financial market cycles are inconsistent and full of random elements. However, even with their randomness, market cycles do have discernable patterns; rising, peaking, falling, and bottoming. When markets rise, we go from optimism to euphoria. The overwhelming urge, at this point, is to pour money into the market and concentrate it in the hottest sectors. Near the peak of the cycle, we are full of confidence and know we are doing the right thing. Once markets start falling, our optimism turns to anxiety and we begin questioning our decisions. Our confidence is shaken, but we hold on by reminding ourselves to think long-term. Finally as the downturn accelerates and losses mount, fear and panic convince us that we are dreadfully wrong and we need to get out.

Our emotional responses to different market cycle stages is not bad, it is normal. It's reacting to these emotions that creates the problem. Morningstar's Investor Returns tool, which compares the returns investors actually earned to the returns their mutual funds earned, shows that investors significantly under-perform their funds because they move money in after gains and out after losses. They buy high and sell low, understandable but costly. According to Dalbar Inc., the Boston based investment research firm, the average investor loses two-thirds of their potential return due to poor decisions. They calculated that between 1986 and 2005 an S&P 500 index fund earned almost 12%, but the average mutual fund investor earned less than 4%. The average professional didn't do much better. According to Anders Ericsson, who *Time* magazine called the world's leading expert on experts, experienced professional investors "...are barely better than novices."

So, if you can't trust your feelings and you can't trust the experts, who do you trust? You trust the things that consistently make a difference; you buy index funds, you broadly diversify across different asset classes, you keep costs low, and you decide to stay the course when things look hopeless. And how do you stay the course? That's easy, "If it feels right, don't do it!"