Managing the Emotions of Investing **Second Quarter 2018**

'Consensus' might be one of the most commonly used words when speaking about investing or the economy. We often hear 'consensus estimates' or a 'consensus of economists' or similar phrases. It is comforting to be in agreement. Collaborating in harmony with others, especially those that are professional colleagues, is reassuring. Consensus helps validate a belief or an idea. When it comes to investing, however, one must avoid turning consensus into groupthink. Challenging consensus through critical thinking, when prudent, is crucial to producing successful investment outcomes. Groupthink leads to herd behavior, which can contribute significantly to the formation of asset bubbles.

This type of behavior also leads to something called 'recency bias', or the tendency to place more weight on fresh evidence and events. Dan Ariely, a professor at Duke University who has studied the psychology of investors, explains: "We look at the most recent evidence, take it too seriously, and expect that things will continue in that way," he wrote. It is part of our DNA as humans.

Let's look at some real examples of how emotion can negatively affect investing due to recency bias:

- In early 2008, though trouble had begun to appear in the housing markets, Wall Street was still predicting gains for stocks. A consensus of analysts anticipated a return of 11.1% for the market. We all know that 2008 was an extremely bad year for investors; the devastation in the equity markets erased a decade of gains. Those market 'pros' were biased in their outlook due to the previous five-year period that saw strong gains for stocks.

- In 1999, one couldn't open the newspaper or turn on the television without seeing stories of internet stocks making huge gains, sometimes more than 100% in a year. Looking back, it was clearly dot-com mania. For the 2000 Super Bowl, 17 internet companies had paid $44 million to advertise, according to a subsequent Bloomberg report[1]. One year later, only three dot-com companies ran ads during the game. Despite a flurry of internet companies going public and increasing significantly in value, the trend was unsustainable. But the fear of missing out, and the bias created by huge gains in the stocks of internet securities, helped fuel the bubble.

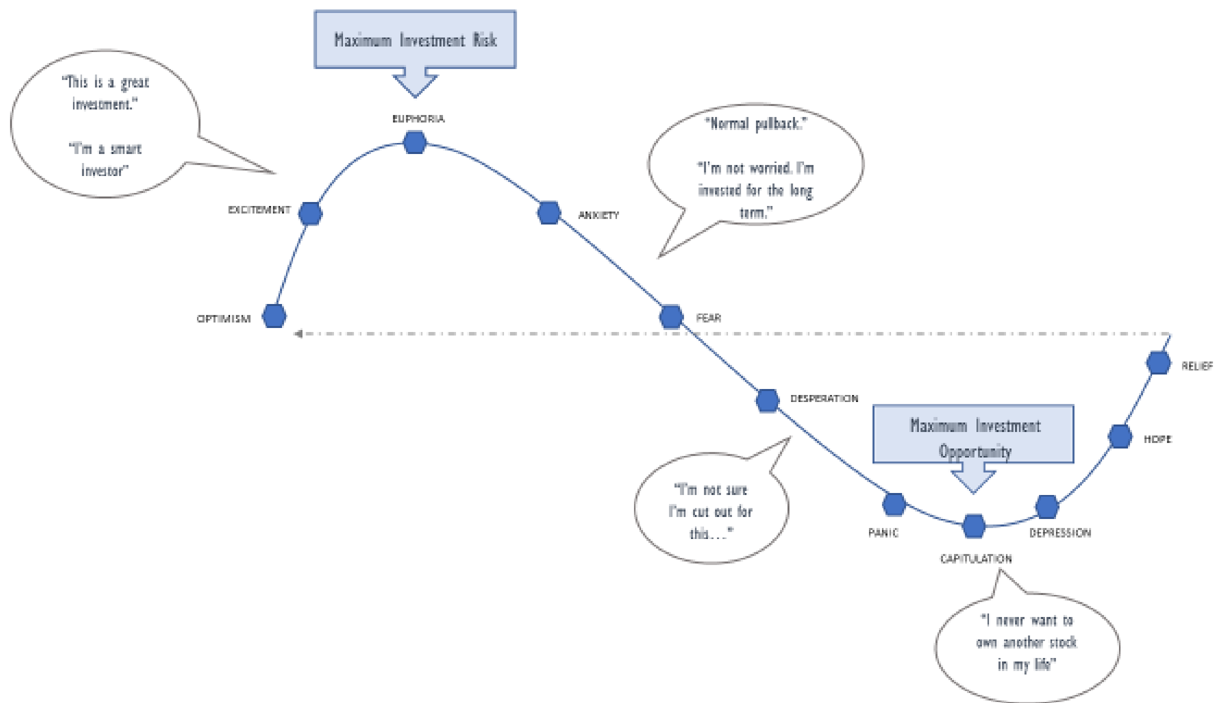
Such frenzy is not unique to market tops. There were many signs that investors had given up on stocks prior to the market bottoming in March of 2009.

- The United States Treasury held an auction for Treasury Bills that paid 0% in early 2009. To buy these bonds an investor had to pay a fee. So, one effectively gave money to the Treasury, received no interest (0% coupon), and had to pay a fee. It was a losing transaction. It looked like this:
  - I have $10,000 (perhaps from selling stocks at a huge loss)
  - The government offers me the security and guarantee, through a promissory note, of returning that $10,000 after a stated term (in this case I believe it was one year)
  - These bills pay 0% interest (0% coupon) and require me to pay a $50 transaction fee.
  - One year later I get back $9,950.

  It would be hard to find a better example of extreme fear of loss. A skilled investor, able to identify extreme emotion, would have heavily favored equities over bonds at this point.

[1] https://www.bloomberg.com/news/articles/2001-01-07/whats-missing-from-super-bowl-xxxv

In client meetings, I often pull out the following illustration of investors' emotions. Recency bias is evident on the way up, as optimism grows towards euphoria, and again on the way down as emotions reach the point of depression. The cycle is real and we've all experienced it.

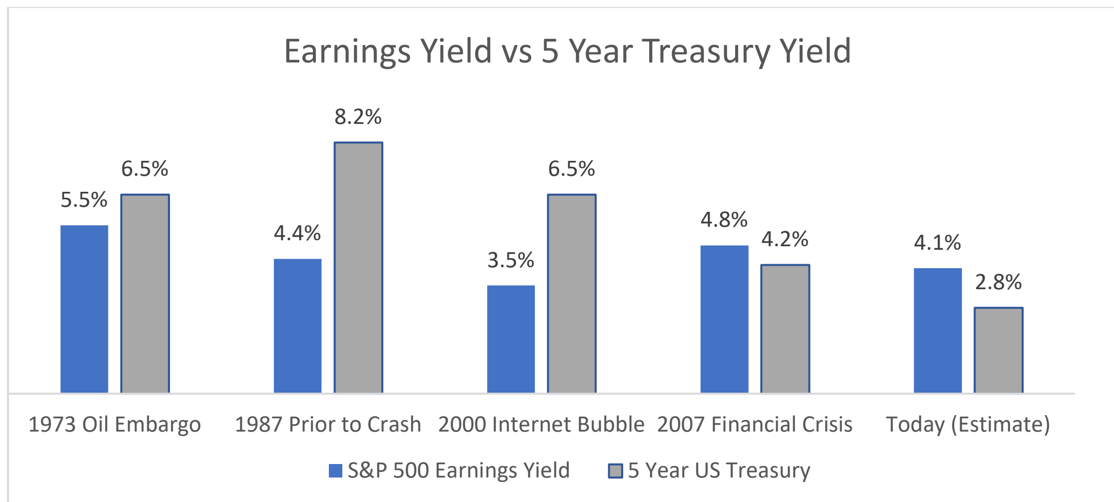


2018 Mid-Year Update: Valuation, Relative Opportunity, Sentiment

Measuring the psychology of market participants is critical to understanding markets at major turning points, but it is only part of the equation. And it isn't always actionable. Rarely, if ever, will we make wholesale changes ("sell everything!") by positioning our clients in total opposition to the crowd. The team at Napatree Capital is disciplined about taking a long view, being patient, and ignoring the noise and emotions of the market. We construct client portfolios to achieve long-term objectives.

As advisors we want to be armed with the appropriate information to speak candidly with our clients and set expectations accordingly. The three elements that form our investment decisions are an analysis of valuation, an understanding of sentiment, covered above, and the relative opportunity of investment choices (e.g. stocks vs bonds). So where are we today?

- **Valuation**. One measure we use to understand valuation is earnings yield. Basically, if we took a company's earnings and paid all of it out in the form of a dividend, then divided that by the price of the company's stock, that would be the yield. It can be used for individual companies as well as the broader stock market. Today the yield is 4.1% on the 500 stocks that make up the S&P. That is quite low from a historic standpoint. It means that estimates for companies' earnings need to continue increasing, so stocks are trending toward overvalued. Or the share prices of the companies that make up the S&P 500 need to adjust lower.
- **Opportunity.** However, we don't look at earnings in a vacuum. For example, comparing earnings yield to the yield on a 5 Year Treasury note is interesting. When investors favor stocks over bonds, bonds get sold, which drives the price of bonds down. That causes the interest rate – the effective yield – on bonds to rise. Now let's look at the relationship between the earnings yield on stocks to the yield on a risk-free asset (backed by the full faith and credit of the United States government).

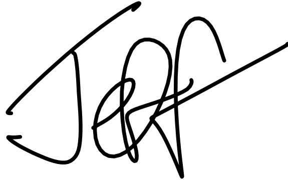


We monitor this relationship closely. It ties into our belief in relative choices, or opportunity. In past peaks, notably 1987 and 2000, there was a clear and compelling reason to own short term treasury notes. An investor has choices and finite capital. Is it worth taking the incremental risk in stocks over an asset that is almost entirely risk free? At this point, it is not yet compelling to reduce our exposure to equities, but we are moving closer to that point.

- **Investor Sentiment.** A multitude of data exists today that helps depict how investors *feel* about markets. For example, there is a survey of investment managers (us!) asking about, among other things, their recommendations for owning stocks vs. bonds. At times the answers are heavily skewed in favor of owning stocks, but remember: as a contrarian, that is a warning sign. Most current indicators show a preference for owning stocks – sentiment is more bullish than bearish – but not overwhelmingly so. In the emotional cycle chart above, we are not close to euphoria. That doesn't mean clear sailing ahead, as we could still suffer a shallow selloff in stocks, but major market peaks arise from an abundance of positivity from market participants. That is not the present case.

Investment management is a dynamic process. We examine valuation, the relative attractiveness of investment choices, and investor sentiment regularly. It helps us stay disciplined and means we rely on data and not emotion when making investment

decisions. Gut reactions lead to wealth destruction; it is the antithesis of discipline. I still cringe when I see the headlines in the financial media, tying market moves to a weekly retail sales number or a change in the unemployment rate, or a comment or tweet by an influential individual. Most of it is just noise. Which leads to confusion, exasperation, and possibly, a nap. We are all far too busy to be napping now.



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