The Psychology of Investing

March 31, 2021

Stanford Professor Scott Sagan once said something everyone who follows the economy or investment markets should hang on their wall: “Things that have never happened before happen all the time.”

History, from Greek – historia, meaning “inquiry,” is the study of the past. In most cases, it is the study of surprising and big events in the past, and investors use it as an unassailable guide to the future. Isn’t that ironic? Do you see the problem?

We’d agree it is smart to have a deep appreciation for economic and financial history. It helps us calibrate our expectations, understand where people tend to go wrong, and offers a rough guide of what tends to work. But it is not, in any way, a map of the future.

Investing is not a hard science. You’ve heard us state emphatically that it is some form of art, too. Why? Because it entails a massive group of people making imperfect decisions with limited information about things that will have a significant impact on their well-being, which can then make smart people nervous, greedy, or paranoid. A famous physicist once said, “Imagine how much harder physics would be if electrons had feelings.” Oh boy, investors have feelings all right! Lots of them. Predicting what they will do next solely based on what they may have done in the past is unlikely to work in the long run.

The cornerstone of economics is that things change over time. Things don’t sit still. Culture and generations change. The life force of the world is ebb and flow. There are high tides and low. And the world will continue to be full of surprises. The “Invisible Hand” dictates things neither stay too good or too bad for long. Long time investor and author Bill Bonner described how Mr. Market works: “He’s got a Capitalism at Work t-shirt on and a sledgehammer in his hand.” So, as we look ahead to the next few years, we should expect surprises and plan for your plan to not go exactly according to plan.

Let us explain. Did you know some of the best smart financial behavior can be found in Las Vegas? Well, some of the worst, too, of course! But among players at the blackjack table, you may find one or two who practice something called card counting. What they do is important to understand about managing money.

The theory and fundamentals are simple; no one can know with certainty what card the dealer will draw next. But by tracking what cards have already been dealt you can calculate what cards remain in the deck. Doing so can tell you the odds of a particular card being drawn next by the dealer. As a player, you increase the size of your bet when the odds are in your favor and less when they are against you.

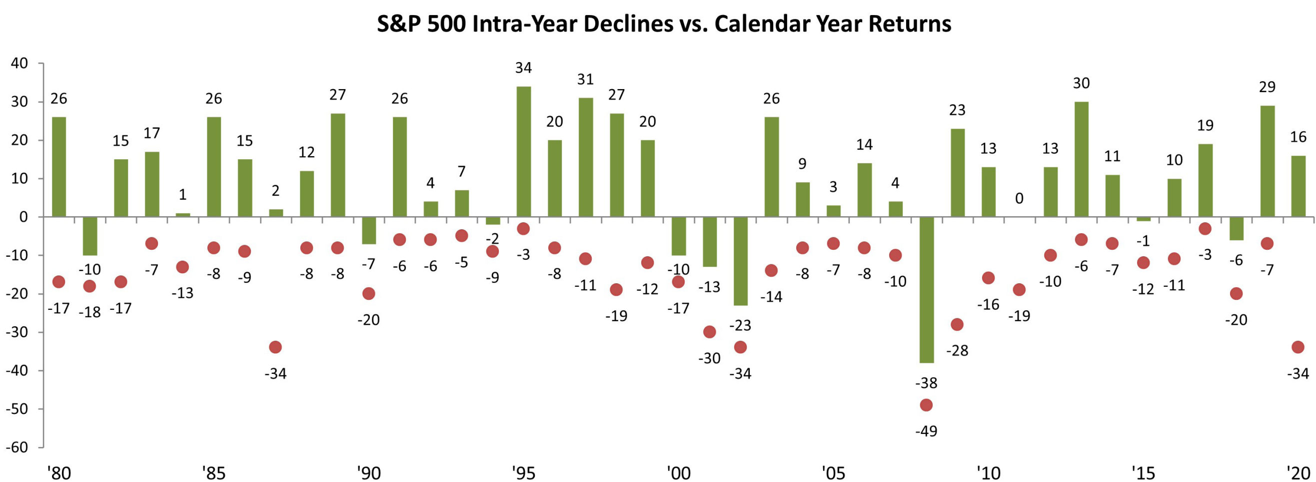
What matters here is you are playing a game of odds, not certainties. In any hand, you know there is a chance of being right, but a decent chance you could be wrong. This strategy forces the blackjack player to be humble as they don't know and cannot know exactly what's going to happen next. The reason it works is that it tilts the odds slightly in your favor, and that slight advantage, over a long period of time, will shift the winnings to your side of the table. Statistically, card counting is proven to work, but it does not guarantee you will win on every trip to the casino!

The humility part acknowledges that uncertainty, randomness, and chance "unknowns" are ever-present in our lives. The ability to increase the gap between what you think will happen and what can happen will leave you capable of fighting another day. We reference Ben Graham and his margin of safety when seeking to own great businesses, but only at a price where there is a margin of safety. He said, "the purpose for the margin of safety renders the forecast unnecessary." That can also extend to the potential for surprises and future events that nobody can predict. Almost everything related to money exists in that kind of world governed by odds, not certainties.

The margin of safety allows investors to think of the world not in black and white with its predictabilities and certainties, but within the grey area, pursuing things where a range of outcomes are possible.

Considering a range of possibilities is an endeavor we cannot emphasize enough. Volatility over the past 12 months has been a harsh reminder that stocks tend to go up in escalators and down in elevators. Selloffs are emotionally taxing because they tend to amplify loss aversion and other powerful emotional responses. As declines worsen, many investors simply throw in the towel because they can no longer take the pain.

The chart below explains why panic selling is almost always a bad idea. Green bars represent the annual price return of the S&P 500 each year since 1980. Maroon dots below highlight the largest drawdown (peak-to-trough decline) each year.



For example, in 1987, the S&P 500 ended up 2% despite dropping 34% at one point during the year. In 2009, the market dropped 28% at one point but ended up 23%. Last year was a doozey with a large drawdown and a significantly large recovery!

Here's what's worth noting:

- Drawdowns happen annually. This data set is over four decades long, and they occur every single year.
- Since 1980, the average intra-year decline is ~ 14.5%
- Drawdowns are common, but the market ends higher in 78% of the years.
- Over half of the years when drawdowns exceeded 15% or more the market still delivered a positive return.

What does this all mean? Most drawdowns were short-lived. The next time you question your age or investing time horizon, understand drawdowns and big nasty bear markets come and go relatively quickly. Investors who kept cool and resisted the urge to sell were rewarded. This may not always be the case and future surprises and market corrections will always all be unpredictable, but if you keep a margin of safety with your purchase prices, you are afforded the ability to withstand the occasional corrections more readily than someone buying at 52-week highs.

The margin of safety isn't some perfect algorithm -- again the art and science must be accounted for! And to make things even more maddening for you, did you know that since 1916, the Dow Jones Industrial Average made new all-time highs in less than 5% of all trading days, but it is still up 25,500% since that time. That means 95% of the time your portfolio would be less than its all-time high! Think about that! The less you look, the better off you will be.

It's slow and steady that wins the race. Since its inception, the Dow has only been positive in 52% of all days. Also, the Dow has spent more time 40% or more below the highs than within 2% of the highs. That means no pain, no gain – truly remarkable!

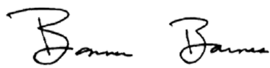
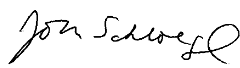
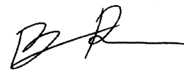
Since we haven't had a good garden-variety correction in the past 9 months, it might be wise to consider that the -14.5% average yearly drawdown could be at hand. One never knows. What's important is many times, high quality companies aren't typically on sale, so we must be patient and let the markets' foibles and follies bring them down, availing the risk averse investor with attractive entry points. We seek to pounce when the dividend yield is attractive, sustainable, and the valuation is below average. If we purchase at a low price point, our future gains can be substantial. Plus, our margin of safety increases if we can achieve a bargain price when shares are out of favor. We use the market to our advantage, and something to emphasize – we attempt to focus on the fundamentals of a business, not especially attempting to predict the overall pace or lack thereof of the economy. We position ourselves for both expansionary and recessionary periods. A business with a strong balance sheet and not overly leveraged with debt can withstand the occasional recession. That's important to us.

On a side note, although one might compare our philosophy to the sporting analogy, "offense wins games, defense wins championships," we want to emphasize our total return objective contains both an offensive and defensive mindset. Capturing those important dividends is a similar priority to attractive opportunities where significant capital gains can be achieved as well. We are capitalist-minded -- you can't stick your head in the sand and expect to get ahead -- can you?!

So, as we roll into April, let's keep a laser-like focus on our objective and not get shaken out when the headlines make you queasy. We can predict with high confidence there will be a headline or two that will make you doubt the future of the economy or the market in general. Recognize there is a range of outcomes, and like the card counter, be humble and patient and strike when the odds are in your favor. Our Director of Financial Planning – Randy Kratz, likes to say; "Worry is born in the gap between expectations and reality. When you reduce that gap, less room for worry means more room for having fun." We are here to navigate the capital markets and to help reduce that gap.

We appreciate your confidence in the entire CORDA team, and we are grateful to have accomplished so much in the past 12 months and are dead set on keeping you on track to meet your goals.

All the best from the entire CORDA Team.

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