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Commentary

Emotional Decision Making Can Be Hazardous to Your Wealth

By: SEI Investment Management Unit

"The long, sad history of market timing is clear: Virtually nobody gets it right even half the time. And the cost of getting it wrong wipes out the occasional gain of getting it right."

Charles Ellis, Winning the Losers Game

Human emotions and the behaviors they give rise to have been shaped over hundreds of thousands of years, in environments and pursuits far removed from the modern world. As a result, the hard-wired behavioral tendencies conferred on us by natural selection sometimes work against us. This is especially true in investing, where long-term success requires that we learn to manage our emotions and avoid panic-driven decision making.

The 24/7 News Cycle and Investor Emotions

Thanks to the information technology revolution, people are now able to follow events around the world 24 hours a day, seven days a week, 365 days a year. This constant news flow often contains unpleasant surprises that are well out of any individual's control. Experiencing emotional reactions to them is inevitable.

When the news is related to financial markets, these reactions can be especially visceral for investors, who are left to wonder, "How will this latest bit of news impact my portfolio and my net wealth?" The scarier the news or the more severe the market's reaction to it, the more likely investors are to panic. In pre-modern settings, natural selection may have favored those who were the first to drop everything and head for the hills. Today, those instincts can undermine an investor's ability to plan and work towards a financially secure future. Instead of buying low and selling high, emotionally-driven decision-making leads them to buy high and sell low.

Don't Shoot Yourself in the Foot

A better question for investors to ask when facing fear and uncertainty is, "What impact will panicking and abandoning my investment strategy, even temporarily, have on my chances for long-term success?" The answer is not encouraging for those who attempt to time the market in order to escape periods of turmoil and discomfort.

For example, multiple academic studies have found that mutual fund investors tend to be their own worst enemies, consistently erasing a significant proportion of their returns with their trading decisions.[1] In its annual report on investor behavior, research firm DALBAR has found that investors tend to time their sales and purchases of mutual funds most poorly when stock markets are under pressure.[2] And Morningstar has found that due to poorly timed buy and sell decisions, investors in almost all types of mutual funds have realized lower returns than the funds themselves, as shown in Exhibit 1 on the following page.

[1] For example, see Philip Maymin and Gregg Fisher, "Past Performance is Indicative of Future Beliefs," *Risk and Decision Analysis (forthcoming)*, April 29, 2011, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1746864>, accessed on September 20, 2011.
[2] Dalbar, Inc. Research & Communications Division, "2011 QAIB: Helping Investors change behavior to capture Alpha," Dalbar, Inc., Boston, March 2011, p. 12 (Guess Right Ratio).

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Exhibit 1: Difference Between Average Investor Returns and Average Total Returns[3]

Time Period	U.S. Equity	Taxable Bond
1 Year	-2.00%	-1.38%
3 Years	-0.22%	-0.52%
5 Years	-0.27%	-0.57%
10 Years	-1.37%	-1.06%

Source: Morningstar, Inc., SEI
Notes: (1) Figures are annualized, based on monthly data through 12/31/2010. (2) Investor returns are dollar-weighted returns for open-end mutual funds and exchange-traded funds; this measure accounts for the cash inflows and outflows resulting from investors' fund purchases and sales, and is designed to measure how an average investor fared over the measurement period. (3) Total returns are time-weighted, which means that they indicate the return (change in fund net asset value plus net investment cash flows) that would have been realized by an individual using a buy-and-hold approach from the beginning of the measurement period. (4) Table reflects average investor return minus average total return for each fund class.

Investors who utilize an investment manager (for example, in a mutual fund or a separately managed account) should be aware that the success of a manager's strategy is best assessed over one or more complete market cycles, which as an industry rule-of-thumb tend to last between three and five years. However, DALBAR has found that since 1991, the average mutual fund holding period is only 3.27 years for equity funds and 3.17 for fixed-income funds. As they note, "The result is that the alpha created by portfolio management is lost to the average investor, who generally abandons investments at inopportune times, often in response to bad news."[4]

SEI's View

To be a successful investor, you have to keep your eye on an appropriate time horizon, craft an asset allocation strategy that is tailored to your personal needs and tolerance for risk, and stay committed to it through thick and thin. In normal market conditions, that's not hard to do. But in both raging bull and snarling bear markets, remaining committed to a long-term plan takes significant skill, as our hard-wired emotional tendencies make us reluctant to sell or pare back on winning investments and buy or add to losing ones. In other words, it's very unnatural to buy low and sell high; to do so takes plenty of courage and self-control, but it's the key to successful long-term investing.

[3] Russel Kinnel, "Mind the Gap 2011," Morningstar, Chicago, Il., February 15, 2010, <http://advisor.morningstar.com/articles/fcarticle.asp?docId=21704>, accessed on September 20, 2011.
[4] Dalbar, Inc. Research & Communications Division , *op. cit.*, p. 10.

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