Financially Speaking
With Trisha Arndt

A Short Memory Can Cost You in the Long Run

"I am not as concerned about the return on my money as I am the return of my money."
Will Rogers

My, what a short memory we have.

I've noticed an unnerving trend in recent financial writings and even in the questions that I get asked by clients. Several people have suggested shifting investments almost exclusively to stocks, eliminating positions in "boring" things like bonds in order to try and ramp up returns. I've even heard rumblings about forgoing investment management completely and instead investing directly in something that tracks a stock index. After all, who needs a manager deciding what companies are attractive to buy when it seems like everything is going up?

Really? Have investors collectively forgotten the pain of the Great Recession so quickly? Granted I was more directly impacted by the roughly 60% decline that stocks endured (as measured by the S&P 500 Index) than most, but I know that seeing those account values plummet was painful for everyone. I realize the market bottomed just over two years ago but are investor memories really that short?

It is easy when things are going good to forget how painful it is when values are falling. We see our 401k and investment account values rising and we want more, more, more. Too often greed takes control and rational thought goes out the window. Investors shift bigger and bigger portions of their money to stocks, chasing the attractive performance numbers and forgetting the principals of diversification and risk management.

And when the next market correction occurs – and believe me, at some point it will happen – investors find themselves penalized for a portfolio that took more risk than they were really prepared to handle. Too often the shock of the losses results in panicked selling at low prices… and the cycle begins again.

Sadly, this cycle is not just a figment of my often too fertile imagination. In fact, many studies have been done proving that average investor returns significantly underperform the investments that they own. Perhaps the most widely cited is Dalbar's annual Quantitative Analysis of Investor Behavior. They have updated and published the study each year for 17 years and in each year the results are the same – investors on average underperform the investment they own because of the psychological impulses that cause them to buy and sell at inopportune times.

Morningstar has done similar studies and last year published an article that looked at the decade past (2000-2009). The article, entitled “Bad Timing Eats Away at Investment Returns” looked at investor performance in different types of mutual fund categories. It concluded that over the decade the grand total average return for investors in all categories was 1.68% per year. The investments themselves for the same time period averaged 3.18% per year. Over 10 years that annual difference really adds up.

I am hardly against owning stocks or other risk assets. In fact I feel that most properly structured investment portfolios will include some allocation to them. Few people however have the time frame and risk tolerance necessary to justify an investment portfolio comprised solely of stocks – especially holdings that track stock indexes and have no ability to overweight individual holdings that may be a better value or have the characteristics that could allow them to hold their value better during declines.

In my January 2010 column I wrote the following, “I encourage each of you to sit down today and write yourself a letter recounting how the last couple of years has affected you and the emotions that you experienced…. Write those feelings down and keep the letter in a safe place. In the future, when you feel tempted to be more aggressive with your investments than an adviser recommends or you are considering a major purchase that you know is only feasible if things continue on an ideal trajectory, take that letter out and remind yourself of how the last two years felt.”

For some of you, it may be time to read that letter.

If you have a question that you would like answered or a suggestion for a topic for a future column please feel free to contact me via email at Trisha@wealthstrategies.biz.

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