Emotional vs. disciplined investing

Last year's lackluster performance and the beginning of 2016 in key stock and fixed income sectors is a perfect segue into why long-term goals and sticking with a carefully crafted investment plan have historically been the best way of managing risk to reach your financial goals.

First, as we've discussed in our face-to-face meetings, your personal situation, goals, and risk tolerance influence your asset allocation (which is the wonky way of saying your investment plan). If your personal situation has changed, we may want to make a mid-course adjustment to your investment portfolio.

But for many investors, the plan that was designed specifically for you remains the best long-term roadmap. Let me explain by highlighting a study published last year by DALBAR, one of the nation's leading financial research firms and one with a 40-year track record.

The study found that over a 20-year period ending December 31, 2014, the average equity stock fund investor posted an average annual return of 5.19%, which compares unfavorably to the average annual return for the S&P 500 Index of 9.85%.

Going back 30-years, DALBAR paints an even gloomier picture, with the average equity stock fund investor earning 3.79% annually versus the S&P 500's average annual gain of 11.06%.

As the study underscores, "Investor underperformance is present in all investment classes, therefore proving (the word it used in the study) that the failure is not primarily one of poor asset allocation."

Let us be clear, our goal has never been to match or outperform the S&P 500 Index. We believe that markets are efficient reflecting all information in fair prices. Using an evidence based approach we design asset allocation targets and portfolios around risk-return parameters and global diversification.

An all-stock portfolio, even one that is fully diversified, is too risky for most investors. We typically recommend a fixed-income component that not only reduces overall volatility but creates a steady stream of income.

So what may be the causes of such woeful underperformance?

Some of the causes of underperformance are varied but may simply have to do with everyday cash needs and unplanned expenses. We completed your initial plan and as we update every year we remove (to the extent possible) the everyday cash needs by creating cash positions in your portfolio and purchasing investments that pay income. We talk consistently about creating an emergency fund for those unplanned expenses.

Once you have the emergency fund in place (your now money) you can then begin investing in the stock market (your later money) to achieve a higher return.

The study concluded that the largest contributor came under what it called “voluntary investor behavior,” which generally represents “panic selling, excessively exuberant buying, and attempts at market timing.” Prudential took the study one step further and analyzed equity cash inflows and outflows over the last 20 years ending December 31, 2014.

Not surprisingly, investor interest was the highest when shares peaked in 2000 and outflows were largest when prices approached the bottoms in 2002 and 2009. It’s what happens when emotions get in the way of a disciplined approach.

Honestly, we get it. There is a temptation to sell when stocks are in downdraft, as we briefly saw last year and are seeing in the early part of 2016. But as we have repeatedly stressed, your financial plan takes into account those hard-to-time downturns, which leaves you well positioned when prices inevitably move higher in the equity market.

Here is a table on returns for US equity asset classes:

Period Returns (%)

Asset Class	1 Year	3 Years*	5 Years*	10 Years*
Marketwide	0.48	14.74	12.18	7.35
Large Cap	1.38	15.13	12.57	7.31
Large Cap Value	-3.83	13.08	11.27	6.16
Large Cap Growth	5.67	16.83	13.53	8.53
Small Cap	-4.41	11.65	9.19	6.80
Small Cap Value	-7.47	9.06	7.67	5.57
Small Cap Growth	-1.38	14.28	10.67	7.95

** Annualized*

Source: Dimensional Fund Advisors, LP

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: Market wide (Russell 3000 Index), Large Cap (S&P 500 Index), Large Cap Value (Russell 1000 Value Index), Large Cap Growth (Russell 1000 Growth Index), Small Cap (Russell 2000 Index), Small Cap Value (Russell 2000 Value Index), and Small Cap Growth (Russell 2000 Growth Index). World Market Cap represented by Russell 3000 Index, MSCI World ex USA IMI Index, and MSCI Emerging Markets IMI Index. Russell 3000 Index is used as the proxy for the US market. Russell data © Russell Investment Group 1995–2016, all rights reserved. The S&P data are provided by Standard & Poor's Index Services Group.

Here is a table of bond index returns:

Period Returns (%)

* Annualized

Asset Class	1 Year	3 Years*	5 Years*	10 Years*
BofA Merrill Lynch Three-Month US Treasury Bill Index	0.05	0.05	0.07	1.24
BofA Merrill Lynch 1-Year US Treasury Note Index	0.15	0.20	0.28	1.78
Citigroup WGBI 1−5 Years (hedged to USD)	1.00	1.17	1.58	2.90
Barclays Long US Government Bond Index	-1.16	2.55	7.65	6.67
Barclays US Aggregate Bond Index	0.55	1.44	3.25	4.51
Barclays US Corporate High Yield Index	-4.47	1.69	5.04	6.96
Barclays Municipal Bond Index	3.30	3.16	5.35	4.72
Barclays US TIPS Index	-1.44	-2.27	2.55	3.94

Source: Dimensional Fund Advisors, LP

As you can see, you will create wealth in financial markets. You have to resist the temptation to try to time the markets. Markets are efficient and capitalism will make you money over time.

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