Bubbles and Elevators

Volumes have been written on behavioral finance and the seemingly "irrational" decisions investors tend to make to avoid straying from the herd. This article examines a current example coined "FOMO" (fear of missing out), in today's texting parlance. Through a better understanding of the psychological dynamics of bubble mentality, we hope to help investment managers better grasp the complex role they must play when their concern for poor expected returns and higher levels of risk are pitted against their client's fear of not keeping pace with the market.

Candid Camera

Allen Funt and Candid Camera filmed a famous episode designed to show how humans tend to behave like each other, regardless of the logic in doing so. In their experiment, an unknowing man entered an elevator, followed shortly by a few Candid Camera actors. After entering the elevator, the actors faced the rear of the car. The man, clearly befuddled, slowly turned around and faced the rear of the elevator. In a second skit, another man not only followed the actors and actresses facing backwards, but then proceeded to rotate back and forth with the crowd. As the skit goes on, he also removes his hat and puts it back on following the actions of the actors and actresses.

While the skits were meant to be humorous, they clearly highlight the innate desire that humans have to follow the actions of others, regardless of whether there is any sense or logic in such actions. The Candid Camera skits can be viewed by clicking here.

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From time to time, financial markets produce a similar behavioral herding effect as those described above. In fact, the main ingredient fueling financial bubbles has always been a strong desire to do what other investors are doing. As asset bubbles grow and valuation metrics get further stretched, the FOMO siren song becomes louder, drowning out logic. Investors struggle watching from the sidelines as neighbors and friends make "easy" money. One by one, reluctant investors are forced into the market despite their troubling concerns.

Justification for chasing the market higher is further reinforced by leading investors, Wall Street analysts and the media which use faulty logic and narratives to rationalize prices trading at steep premiums to historical norms. Such narratives help investors convince themselves that, "this time is different", despite facts evidencing the contrary.

To better appreciate the history of financial bubbles and the behavioral traits they seem to share, we recommend reading "Manias, Panics, and Crashes" by Charles Kindelberger. In the book, Mr. Kindelberger gives detailed analysis of numerous financial bubbles that were built on false premises and wild popularity.

Limiting Losses Redux

In "Limiting Losses" we detailed the basic math that explains how consistent positive returns, even if relatively small, provide a powerful compounding effect that has proven to be an efficient way to accumulate wealth. Such a "boring" investment style tends to outperform one with a volatile path that includes larger gains but significant losses on occasion. It is with this conservative mindset that investment managers should focus on the task of building wealth over the long term and aim to avoid the pitfall of large drawdowns at all cost. This logic is equally appropriate at market bottoms. Some of the greatest investment opportunities have occurred when the majority of investors were panicked and selling despite compelling valuations.

Dare to be Different

As a fiduciary of your client's wealth, you are paid and trusted to quantify and understand the potential risks and rewards and invest their wealth accordingly. You cannot fall prey to periods of grossly unwarranted market optimism, nor should you be shy to invest during periods of deep pessimism. Avoiding these natural instincts, like not turning with the crowd in an elevator, is difficult to put it mildly.

While there are many ways to keep a level-headed approach, we think there are two concepts investment managers should consider:

Investment Strategy and Goals - Create appropriate investment strategies that encourage steady, long term returns. To do this, managers must have rules in place to limit exposure to assets that are overpriced, and increase exposure to those that are underpriced. They should also encourage clients to allow inclusion of a wide variety of permissible assets to make this task easier. Furthermore, understanding the correlation between portfolio assets during severe market drawdowns and periods of crisis is a key risk management metric that should be closely followed.

The task above is made easier when clients have clear and concise objectives that stress long term wealth management. When managers benchmark their clients' performance to that of the stock and/or bond market, they are blindly aiming for a return that does not correspond with their clients' wealth objective, but to the whims of other investors. A clear wealth building objective would be to outperform inflation by a given margin or, in other words, increase purchasing power. That said, we know most managers and their clients are programmed to compare investment results to market returns. To see the problem with such a goal, consider a manager who in 2008 said "we were only down 30%, while the market dropped 50%, didn't we do well?" NO!!! The clients' wealth decreased significantly.

Obviously, proper investment management and strategic goal setting is a complex and time consuming job. We do not make light of that or the "way things are done" by the vast majority of investment managers. Our point is to stress that when you buy what is cheap, sell what is expensive and sit on additional cash at appropriate times, your odds of long term investing success increase dramatically. As Warren Buffett said, "the stock market is a no-called-strike-game". Successful investors understand that you can look at as many pitches as you wish until you get one you know you can hit – the proverbial "fat pitch".

Client Education - The second requirement for taking an out-of-favor investing posture is properly educating clients on that approach and managing their expectations. First, clients need to understand and be consistently reminded that your goal is to grow their wealth over the long term, which is best done by avoiding losses. Contrast this perspective with the anxiety most investors feel because their returns are not keeping up with the Dow Jones Industrial Average or their neighbors'. Waiting for good opportunities and avoiding losses is the long game of wealth creation. Eliminating the short-term view of wealth management that most investors harbor is important.

The hardest part of helping clients understand this goal is convincing them that, at times like today, the market is fraught with risks. Ironically, such an environment fosters a sense of urgency, FOMO and a perceived need to "chase returns".

In order to help investors understand the approach, a manager must clearly, succinctly and repeatedly explain their thesis on markets, particular investments, and economics. A client can more easily avoid popular investment urges when their manager has explained the logic behind a posture that is more conservative or aggressive than the norm. This can be accomplished through frequent verbal and written communication.

Summary

TINA is another popular acronym - "There Is No Alternative". We think there is an alternative to chasing assets whose valuations imperil client wealth. Focus on the fundamentals that underpin stock prices and own securities that are appropriate given the risk/reward objectives. **Though it is especially difficult to be a contrarian at such times, the reward for doing so is preservation of wealth and the assurance of excellent value opportunities in the future.**

FOMO can also be thought of as FONC "fear of not conforming". As a steward of your client's wealth, it is imperative that at market junctures like the present one, special care is taken to understand the risks and allocate investments accordingly. Timing the market is impossible, but keeping an eye on the long term goals will help your clients avoid the pitfalls (i.e. losses) that inevitably set investors back years. Equally damaging at that point is the inability to take advantage of the multitude of opportunities that no doubt will emerge.

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