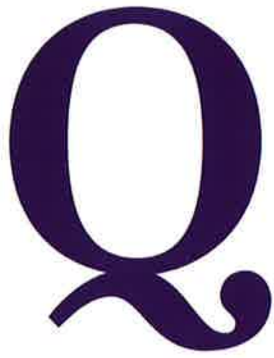

QUARTER NOTES

Third Quarter 2019

Paul R. Mancuso

How to avoid emotional investing

We like to think that since the advent of modern portfolio management practices, investing in stocks and bonds has become a cerebral, analytical process with no room for emotion. The truth is that most investors, even institutional investors, are buffeted by emotional turbulence from time to time, and that truth is reflected in the volatility of the financial markets.

But if a little emotionalism when it comes to investments is unavoidable, too much emotion can be hazardous to your wealth. Here are four symptoms of problem emotions, financial behavior that is inconsistent with sound investment practice.

Fear of flying

Investors are generally motivated by fear or by greed. Behavioral scientists have learned that, for many people, the pain of loss is larger than the sense of satisfaction from a gain of the same size. Similarly, some investors will accept larger risks in order to avoid a loss than they will in seeking a gain.

Taken to an extreme, fear of loss leads to investment paralysis. An excessively risk-averse investor may park funds in ultra-safe, low-yielding bank deposits or short-term Treasury securities until a decision is

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Emotions and investing

The financial markets can seem surprisingly emotional at times. Individual investors should try to keep emotions at bay, to avoid mistiming their investment moves. That's the theme of our feature article in this issue of *QuarterNotes.*

On page 3 you'll find "Impact Investing." This trend is the successor to "socially responsible" investing, and appeals to some investors.

Do you have questions about your saving and investing plans? Please bring them to us, and put our experience to work for you.

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made, accepting long periods of low returns. Or winning investments may be sold off too quickly in an attempt to lock in gains, while losing investments manage to stay in the portfolio indefinitely.

Herd instinct

It's difficult to be a contrarian, to find value that everyone else has overlooked. Many people find it easier to go with the crowd, to own the current hot stock or hot mutual fund. At least that way, if the investment does poorly, one has plenty of fellow sufferers with whom to commiserate.

But when "crowd" is defined as one's family and friends, the crowd's investment goals may be very different from one's own.

Hair-trigger reflexes

Markets move on news. In many cases, the first market response is an overreaction, either to the up side or to the down. Sometimes "news" is only new to the general public, and it's already been reflected in the share price through trading by those with greater knowledge. The true importance of any news event can only be discerned over the longer-term.

Generally, it's better to watch the market react to news than to be a part of the reaction. Remember that market dips may present the best buying opportunities, but they're also the toughest times, emotionally, for making a commitment to an investment.

Betting only on winners

There is a strong temptation to invest only in domestic equity mutual funds with MorningStar ratings of four or five stars. This may be one reason that the government requires this disclosure for investment products: "Past performance is no guarantee of future results." The disclosure is required because it is true. High returns are usually accompanied by high risks; ultimately, those risks may undermine performance.

Abnormal returns, whether they are high or low, tend to return to the average in the long run. Investing on the basis of the very highest recent returns runs a significant risk of getting in at the top of the price cycle, with a strong chance for disappointment.

The alternative approach

To avoid impulsive decisions that may be tainted with emotion, one needs an investment plan. The best way to moderate the impact of stock and bond volatility in difficult markets is to own some of each. Assets do not move up or down in lockstep. When stocks rise, bonds may fall. Or at other times, bonds also may rise when stocks do. The movements of each asset class can be mathematically correlated to the movements of the other classes. Portfolio optimization involves the application of these relationships to the investor's holdings.

An asset allocation plan is a program of disciplined diversification. To oversimplify, there are three steps:

Step One. Determine the expected return from each asset category—stocks, bonds, and cash. Expected returns may be determined for subcategories as well—small company stocks, corporate bonds, intermediate maturities, and so on.

Step Two. Decide which combination of these asset classes offers the best return for a given level of acceptable risk.

Step Three. Given target allocations, select investments within each class for the portfolio.

Expected returns need to be linked to the investor's time horizon. Longer time horizons give the investor more time to recover from bad years, more chances to be in the market for good years.

Riding the roller coaster

Investor's emotions can run in cycles, just as the markets do. One begins with high hopes and optimism, and success may bring a kind of euphoria. However, even with success anxiety may set in, as one worries about protecting the gains. Should there be a setback, fear and even panic can be the result. That's when courage is needed, to avoid selling at the bottom. If capitulation does occur, hope must be restored before one is willing to return to try again.

One approach to staying off the roller coaster of emotions is to work with an investment advisor to help in maintaining a long-term perspective.

We can help with your investments

We take investing very seriously, but not emotionally. We don't claim to be infallible, but we are well informed and able to help you make investment decisions that are suited to your needs and objectives.

"Impact investing"

Looking beyond risks, returns, and balance sheets

The idea that investments may have a moral dimension is not new and may be traced to the 1700s. The Quakers forbade their members to participate in the slave trade, for example. John Wesley, one of the founders of Methodism, advised avoiding investment in companies with practices that injured employee health.

In the 1990s the idea of "socially responsible investing" took shape. The initial idea was to use negative screening to avoid companies that traded in "sin" or "vice," such as tobacco companies, gun manufacturers, casinos, and liquor companies. Some people added oil companies to the proscribed category.

Although screening out disfavored firms may have made investors feel virtuous, it didn't affect the fortunes of those firms in a material way. In fact, the "vice stocks" generally outperformed the market as a whole, because those companies tended to be rather profitable, paying generous dividends to their shareholders.

A less constricting version of socially responsible investing has emerged in recent years, one that employs positive screens or themes as well as exclusions. Three categories of factors are involved: environmental, social, and governance (ESG). An environmental focus may look at carbon emissions, water stress, renewable energy, or pollution. Social factors might be diversity, inclusion, labor, employee welfare, or data security. Governance issues might touch upon independent directors, audit standards, women in leadership, and executive compensation.

Companies may be scored for their ESG performance. They may self-report, or data may be gathered by third parties who then sell the data. These scores may be combined with traditional financial analysis tools in determining which companies are likely to have the desired impact while still providing strong returns to shareholders.

Some have argued that companies with higher ESG scores are less likely to be disrupted by environmental problems, labor relations woes, or governance scandals, and as such may provide superior risk-adjusted returns. It's too soon to answer that question with complete confidence.

Two views

Professor David Snowball made the case for investing in ESG mutual funds in the June 2019 issue of *AAII Journal* ["Investing in Climate Change," p. 12]. He notes that the number of ESG mutual funds and exchange-traded funds rose from 235 to 351 in just one year, citing Morningstar data. Average inflows have exploded from about $135 million in 2012 to $5.5 billion last year. He argues that as millennials enter their peak investing years, they are likely to favor "responsible" businesses, and that should boost returns for those companies. It could be the wave of the future.

On the other hand, Daren Fonda, contributing to a Barron's Special Report on "investing With Purpose," observes that mutual funds that refer to ESG in their prospectuses held just $161 billion at the end of 2018, compared to the total $22.1 trillion in U.S. fund assets. ESG funds appear to be a niche product at this time, essential offerings for a few investors but not a critical priority for many others.

Several obstacles will need to be overcome. One is definitional, as there is some uncertainty about what counts as an ESG asset or strategy. Another is that only 5% of 401(k) plans offer participants an ESG option, and these plans are the primary investment vehicles for many, many families. But Labor Department guidelines can make such offerings problematic for plan sponsors.

These are issues that investors will want to keep abreast of.

Examples of ESG

"ESG" stands for Environmental, Social, and Governance. Concerns about the environment include:

- Climate change policies, plans, and disclosures.
- Greenhouse gas emissions goals.
- Carbon footprint and carbon intensity.
- Water-related issues and goals, such as usage, conservation, overfishing, and waste disposal.
- Green products, technologies, and infrastructure.

Social concerns may include:

- Employee treatment, pay, benefits, and perks.
- Employee safety policies, including sexual harassment prevention.
- Diversity and inclusion in hiring and in awarding advancement opportunities and raises.
- Ethical supply chain sourcing, such as conflict-free minerals and responsibly sourced food and coffee.
- Public stance on social justice issues, as well as lobbying efforts.

Governance covers such areas as:

- Whether executives are entitled to golden parachutes (huge bonuses upon exit).
- Diversity of the board of directors and management team.
- Whether chairman and CEO roles are separate.
- Dual- or multiple-class stock structures.
- Transparency in communicating with shareholders, and history of lawsuits brought by shareholders.

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Just Ask Us

I'm about to begin receiving Social Security benefits. I'll be 68 when benefits start. I've been told I can get a lump sum payment of benefits by electing a retroactive start date. How does that work?

Yes, you are eligible to choose a start date for your Social Security payments up to six months earlier than the date that you file for them. If you choose an earlier date, you'll get a single payment to cover the "missed" months.

However, you'll also get a reduction in your monthly benefits. You've been earning delayed retirement credits of 8% per year, determined monthly. If you choose an earlier start date, you lose some of that credit, and that reduction continues for life.

Actuarially speaking, the benefit does not change. Check with your financial and tax advisors before making any final decision.

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