

JULEX CAPITAL

Behavioral knockout risk

Rob Brown, PhD, CFA

Julex Capital Advisory Board Member, Website www.robrownonline.com



40 Grove Street, Suite 140, Wellesley, MA 02482

Phone 781-489-5398

Email info@julexcapital.com

Web www.julexcapital.com

***“MIT Study Finds Older Men
Are More Likely to Panic Sell
Stocks”***

Lynn Thomasson



The three most dangerous traps

- Liquidity risk
- Next get rich quick scheme
- Behavioral knockout risk

- This is the risk that due to poor planning you are forced to sell at the worst possible time
- Essentially demanding liquidity from the marketplace when little to no liquidity is available
- Results from inadequately considering what your future needs will or might be, and therefore building a portfolio with inadequate liquidity in preparation for these planned or unplanned future needs

- **EXAMPLE** - Buying individual municipal bonds and then subsequently having to sell them before their respective maturity dates.

- This risk has a long and fabled history
- The investment industry has always been and always will be populated by legions of fast-talking promoters, charlatans and outright swindlers
- Who entice the would-be wealthy with scores of seemingly foolproof schemes
- From stock in companies that didn't really exist, to speculation in Florida real estate or California oilfields, to Boston-based conman Charles Ponzi's promise that investors could make a 50 percent return in 90 days' time by investing in a bizarre plan to redeem overseas postal coupons

Next get rich quick scheme - Past offenses

- Bernie Madoff
- Charles Ponzi
- Jordan Belfort (the Wolf of Wall Street, classic pump and dump)
- Bre-X Mining (Michael de Guzman)
- Enron (Kenneth Lay and Jeffrey Skilling)
- WorldCom (Bernard Ebbers)
- Tyco (Dennis Kozlowski)
- The Florida land boom and bust of the 1920s
- Tom Petters (hedge fund scam)
- Ivar Kreuger (The Match King)

Next get rich quick scheme - Today's offenses

- Crypto currencies
- SPACS
- Meme stocks

The three most dangerous traps

- Liquidity risk
- Next get rich quick scheme
- Behavioral knockout risk

Behavioral knockout risk applies to all investments

- But . . . To make it real, to make it simple
- Let's focus on U.S. stocks . . . As defined by the S&P 500 Index

- 10.9% per year since Jun 1921
- 11.3% over the last 35 years . . . Since Sep 1986

- Stocks allow us to participate in future growth, prosperity, new industries, new technologies, and the next generation
- Stocks are a proven and dependable source of return both here in the U.S., but also overseas in the developed and emerging nations, and for well over 150 years


BUT . . . Stocks have their “bad days”


- A bad year (seriously troublesome returns over short 12-month periods)
- Bear markets (long lasting severe declines)

- We react to these with emotion and behavioral bias
- Behavioral biases include
 - Short-termism
 - Belief that recent history will repeat itself
 - Worst of all . . . regret

Nine primary behavioral biases - That cause us to make poor decisions


 **Loss Aversion**
Expecting to find high returns with low risk


 **Narrow Framing**
Making decisions without considering all implications

 **Mental Accounting**
Taking undue risk in one area and avoiding rational risk in another

 **Diversification**
Seeking to reduce risk, but simply using different sources



 **Anchoring**
Relating to the familiar experiences, even when inappropriate

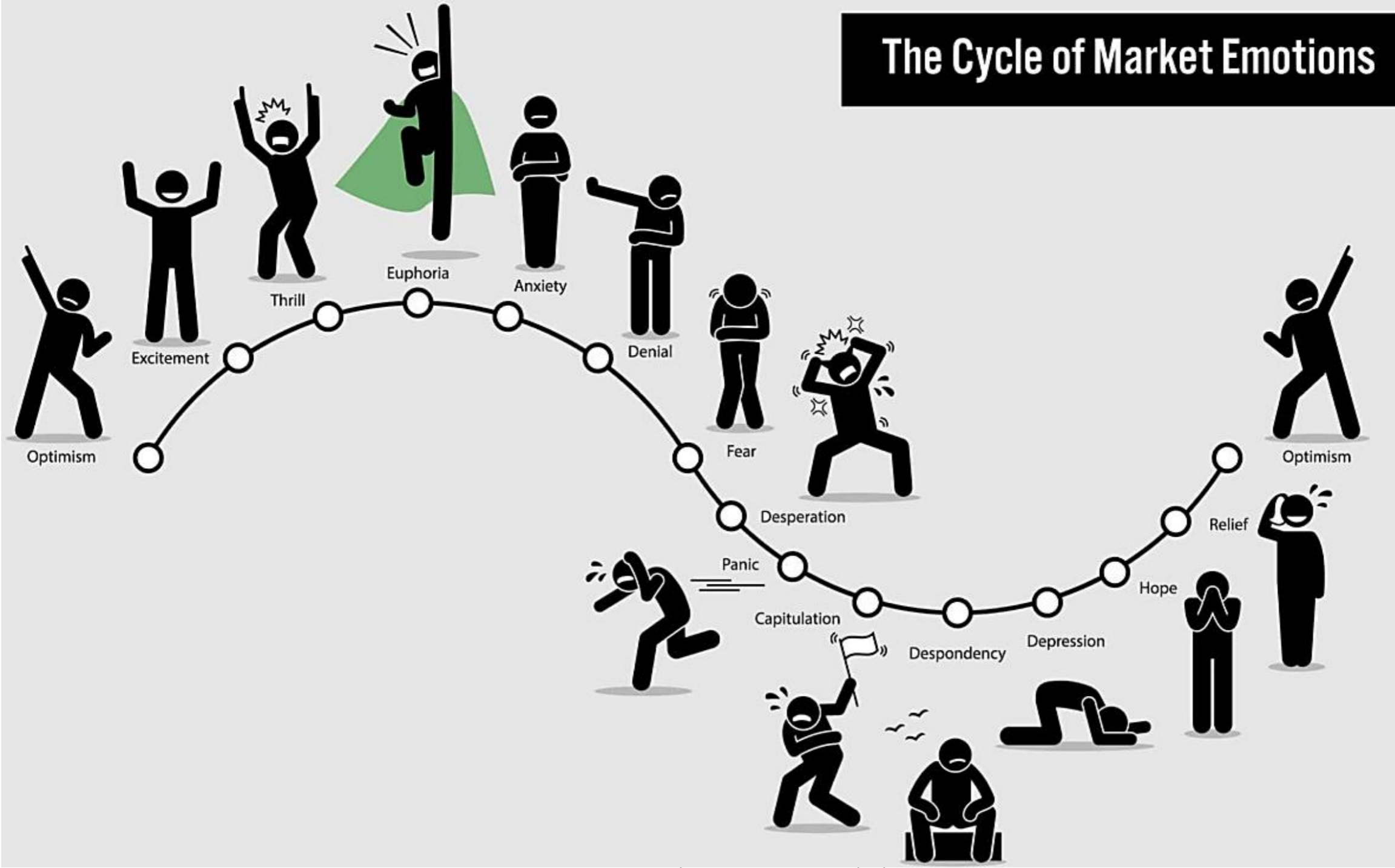
 **Herding**
Copying the behavior of others even in the face of unfavorable outcomes

 **Regret**
Treating errors of commission more seriously than errors of omission

 **Media Response**
Tendency to react to news without reasonable examination

 **Optimism**
Belief that good things happen to me and bad things happen to others

The Cycle of Market Emotions



- **You've been invested since March 2009**
 - Therefore you earned 19% per year
 - But . . . You don't get the same 19% over the next several years
 - So you bail out
- **You've been invested for 35 years (Sep 1986 – present)**
 - Therefore you earned 11.3% per year
 - But . . . You don't get the same 11.3% over the next several years
 - So you bail out
- **What's happening here?**
- **Your initial expectations were NOT set properly**

It all boils down to a simple reality

- Bad things happen
- They always have . . . and always will

- Two main types of “bad things”
 - Bad year
 - Bear market

Total return for U.S. stocks over the 12 months ending on the date indicated

Mar 2020	-7.0	May 1947	-21.1
Feb 2009	-43.3	Jun 1932	-67.8
Sep 2001	-26.6	May 1931	-44.1
Aug 1988	-17.8	Nov 1917	-25.9
Sep 1974	-39.0	Nov 1907	-33.8
May 1970	-23.4	Aug 1893	-24.0
Dec 1957	-10.9	Jun 1884	-18.6

Bear markets . . . what do these look like?

Bear markets for inflation-adjusted U.S. stocks since 1846

Cumulative loss in %	-41	-52	-47	-30	-52	-35	-37	-39	-50
Duration in years	1.65	1.33	2.08	0.25	1.75	1.58	1.75	2.58	1.08
Start of the bear market	Average of the last 16 bear markets	Oct 2007	Aug 2000	Aug 1987	Dec 1972	Nov 1968	May 1946	Sep 1939	Feb 1937
End of the bear market		Feb 2009	Sep 2002	Nov 1987	Sep 1974	Jun 1970	Feb 1948	Apr 1942	Mar 1938
Cumulative loss in %	-79	-48	-27	-37	-32	-35	-31	-30	
Duration in years	2.75	4.08	2.00	1.17	1.25	0.67	0.83	1.25	
Start of the bear market	Aug 1929	Nov 1916	Oct 1912	Sep 1906	Mar 1876	Jul 1864	Dec 1856	Aug 1853	
End of the bear market	May 1932	Dec 1920	Oct 1914	Nov 1907	Jun 1877	Mar 1865	Oct 1857	Nov 1854	

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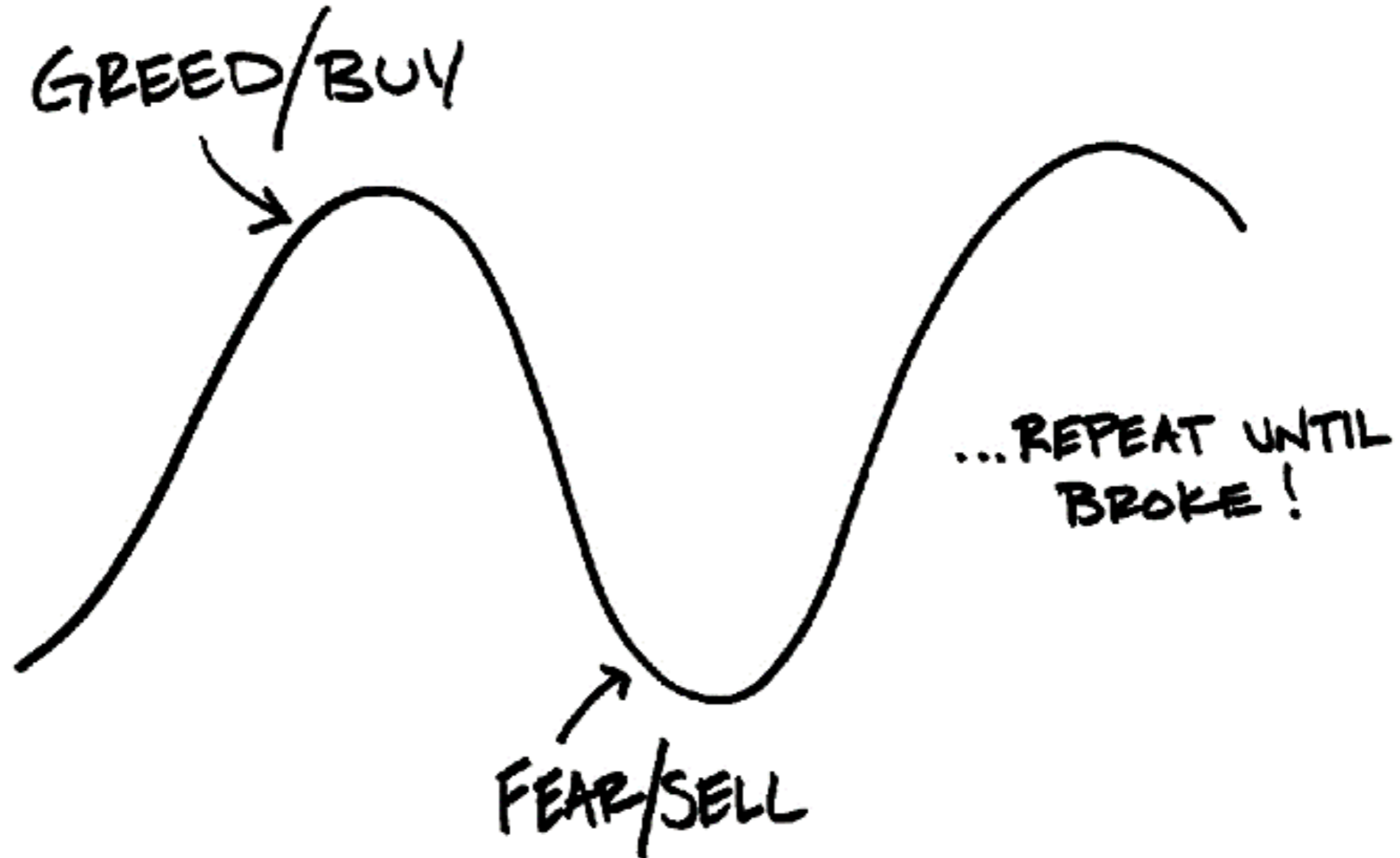
- We only win
- We only make better decisions

- When we set proper expectations for the future
- Next, maintain and reinforce those expectations

- Part of the foundation . . . Is that “bad things” always happen
 - Bad years
 - Bear markets

By appreciating future “disappointments” . . .

- We avoid the following trap the trap of behavioral knockout risk



There remains one additional element underling success

Time Segmentation Investing

- Structure and an approach that separates your assets by the needs that they serve
- Provides them with the time they require to heal and recover from any downturns
- And then subsequently grow to new heights
- This approach makes time your friend

- Sometimes described through the use of an ancient Chinese proverb

“If your plan is for 1 year, plant rice. If your plan is for 10 years, plant trees. If your plan is for 100 years, educate children.”

Collateral

You will find the following client-facing piece . . .

INVESTMENT PERSPECTIVES - OCTOBER 1, 2021



Dreaded behavioral knockout risk - Something you can choose to avoid

Three Traps

The three most dangerous traps to avoid during your investment journey are:

- Liquidity risk,
- Next get rich quick scheme, and
- Behavioral knockout risk.

Liquidity risk - This is the risk that due to poor planning you are forced to sell at the worst possible time, essentially demanding liquidity from the marketplace when little to no liquidity is available. This results from inadequately considering what your future needs will or might be, and therefore building a portfolio with inadequate liquidity in preparation for these planned or unplanned future demands. For example, buying individual municipal bonds and then subsequently having to sell them before their respective maturity dates.

Next get rich scheme - This risk has a long and fabled history. The investment industry has always been and always will be populated by legions of fast-talking promoters, charlatans and outright swindlers, who entice the would-be wealthy with scores of seemingly foolproof schemes - from stock in companies that didn't really exist, to speculation in Florida real estate or California oilfields, to Boston-based conman Charles Ponzi's promise that investors could make a 50 percent return in 90 days' time by investing in a bizarre plan to redeem overseas postal coupons. Some of the more noteworthy promoters included Bernie Madoff, Charles Ponzi, Jordan Belfort (the Wolf of Wall Street, classic pump and dump), Bre-X Mining (Michael de Guzman), Enron (Kenneth Lay and Jeffrey Skilling), WorldCom (Bernard Ebbers), Tyco (Dennis Kozlowski), the Florida land boom and bust of the 1920s, Tom Petters (hedge fund scam), Ivar Kreuger (The Match King). Today is no different, and includes crypto currencies, SPACS, and meme stocks.

Behavioral Knockout Risk

But today, I'm focused on behavioral knockout risk. This risk applies to all investments, but in order to better understand the issue, let's focus on a single investment, i.e., U.S. stocks. Stocks are a great investment. Since Jun 1921 they've returned 10.9%. Or more recently, 11.3% since Sep 1986, i.e., over the last 35 years. Stocks allow us to participate in future growth, prosperity, new industries, new technologies, and the next generation. Moreover, stocks are a proven and dependable source of return both here in the U.S., but also overseas in the developed and emerging nations, and for well over 150 years.

But stocks have their bad days, that unless we can embrace and move beyond, we end up doing exactly the wrong thing at the worst possible time. The two best expressions of stock's "bad days" are:

- A bad year (seriously troublesome returns over short 12-month periods),
- Bear markets (long lasting severe declines).

This is where behavioral knockout risk comes in. We're human, and as such we're driven by emotion and behavioral biases. These behavioral biases include short-termism, a belief that recent history will repeat itself, and perhaps worst of all, regret. The following exhibit identifies nine of these behavioral impediments that cause us to make poor or even disastrous decisions.

For more information contact



Jeff Megar, CFA
Email jeff.megar@julexcapital.com
Office 781-772-1378



Liam Flaherty
Email liam.flaherty@julexcapital.com
Office 781-489-5398

Value is now the time? - Doing it the right way

Friday the 15th

All data and statistics were provided by Global Financial Data, Inc.

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The composition of a benchmark index may not reflect the manner in which a Julex portfolio is constructed in relation to expected or achieved returns, investment holdings, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility, or tracking error targets, all of which are subject to change over time.

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