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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.

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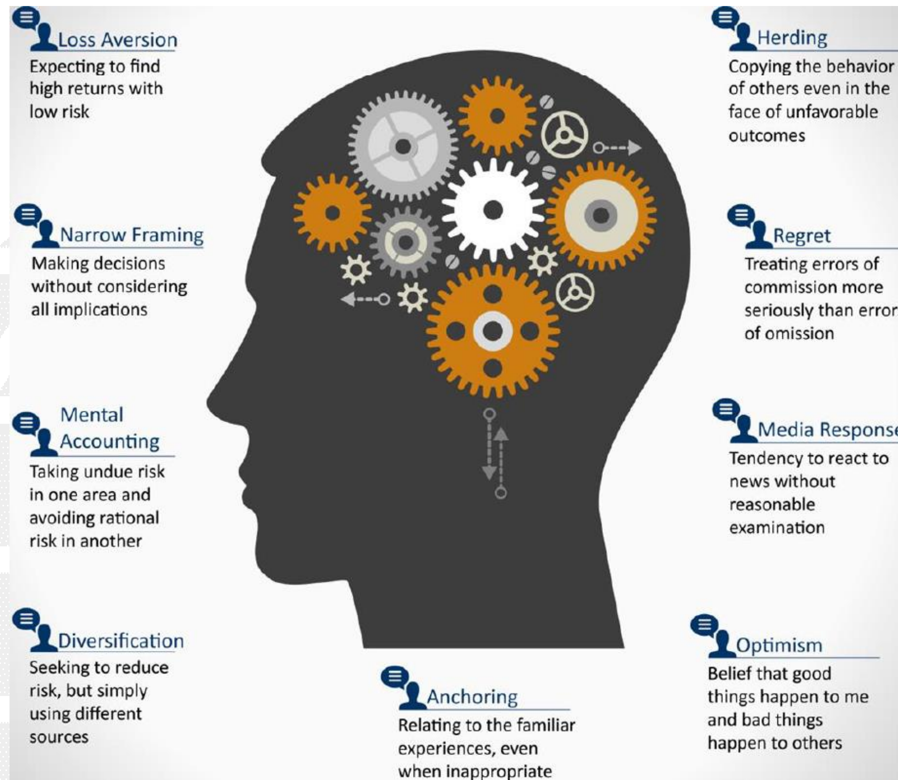

The problem with our emotions and various behavioral biases is that they cause us to react in the worst possible way when the stock market tanks, i.e., we sell when we should be holding or even better, buying. Often, this harmful reaction is because our initial expectations weren't properly set and then subsequently maintained.

For example, maybe you've only been invested since March 2009 and as a consequence have earned 19% per year, on average. Then when you don't get this same 19% over the next several years, you bail out - as a result of incorrect initial expectations. Or you've been invested for the last 35 years (i.e., since Sep 1986) and as referenced above have earned an average 11.3% per annum. Then when you fail to earn this over the next several years, you once again bail - as a result of incorrect expectations.

It all boils down to something pretty simple, setting and then maintaining correct and realistic expectations for the future. Setting these correct expectations is a longer exercise than there is room for here. But there remains one critical and foundational element I do want to cover. And that is that bad things do happen. They always have and always will, and with remarkable consistency. Understanding what these "bad things" look like and how frequently they occur helps us weather the inevitable future storms.

There are two primary types of "disappointment," a:

- Bad twelve months
- Bear market.

The following table provides examples of 12-month time intervals when the U.S. stock market tanked. Unless one understands that these declines are normal, typical, and will always occur . . . we tend to react in the worst possible fashion.

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

Date	Return	Date	Return
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

Stocks are defined as the S&P 500 Stock Index

The same is true for bear markets. Bear markets are defined by declines of sufficient magnitude that they clean out much or even all of the excessive behaviors within the market. The following table provides a history of U.S. stock market bears.

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

	Average of the last 16 bear markets								
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		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

SOURCE: www.robbrownonline.com

The above two tables identify past bumps in the road. But a similar set also lie in the future. By understanding and fully internalizing this, we're better able to stay the course when markets inevitably disappoint.

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Time Segmentation Investing

There is a second component for successfully weathering these future bumps. It's called time segmentation investing. In brief, this is a structure and an approach that separates your assets by the needs that they serve and 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. It is 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."***

Your financial advisor has a menu of time segmentation solutions. The solution that is most appropriate for your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

Rob Brown, CFA, PhD
Julex Capital Advisory Board Member

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Important disclosures

The above stated performance for U.S. stocks was measured by the total return index for the S&P 500 Index and was measured up through and including September 15, 2021

All data and statistics were provided by Global Financial Data.

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