Wealth Management

The Crescent Group

RBC Wealth Management

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March 2019 Investment Commentary

"Average Investor blown away by market turmoil in 2018. DALBAR study shows the Average Equity Fund Investor lost twice the money of the S&P in 2018." That's the headline from the press release issued last week by DALBAR, which has conducted the foremost studies on investor behavior for the past 25 years. In this commentary, we discuss the central factors that led the average investor to perform so poorly last year, and we describe what our Group does to prevent our clients from becoming part of the unfortunate DALBAR statistic[1].

Looking more closely at the study cited above, DALBAR reported that in 2018, the average investor in stock mutual funds and ETFs experienced a loss of 9.42%, compared to a loss of 4.38% for the S&P 500 index. For the 30-year period ending 2016, DALBAR reported that the average individual investor earned a 1.9% annual return, compared to the 8.3% return earned by a balanced blend of stocks and bonds (calculated from the S&P 500 and Barclays Aggregate indexes). DALBAR attributed these unfortunate results achieved by investors to poor behavior. Charles Schwab corroborates this view in reporting that customers shifted assets to cash toward the end of last year, but especially in December, at the peak of the panic. This of course is the exact opposite of what most people should have done. For all of the attention and discussion given to long-term investing and buy and hold, it turns out that almost no one has the discipline to do it[1][2].

Last year's stock market decline reached 20%, the worst decline since the financial crisis ten years ago. It's understandable why many investors panicked and wanted to sell. It was a scary time, and for many the instinct was to sell to "protect" what hadn't declined. The problem with this instinct is that to make money investing over time, an investor needs to buy low and sell high, not buy high and sell low. Panicking and selling when the market declines is the very definition of buying high and selling low. A critical part of our Group's job is to make sure our clients don't become the victims of corrections. When the market tumbles, we do everything we can to keep our clients invested and make sure they don't end up losing twice as much money as the S&P 500 index, as the average investor did last year. A major problem for many investors is that their financial advisors have no more confidence or emotional control than they do, and panic and sell just as much as their clients do during market corrections. It's critical that you find an advisor who has confidence in their investment process, and who has the right mindset to lead you

successfully through market corrections, rather than helping you sell and lock in losses. Every correction in the history of U.S. stocks has been temporary, and the same will be true of future corrections. Panicking and selling as a result of a stock correction certain to be temporary never has and never will make sense, with the exception of certain emergency financial situations (which advisors and their clients should have mostly planned for)[3].

The investment process our Group practices was pioneered by Warren Buffett's mentor Ben Graham during the early 20th century. It treats stocks as long-term ownership positions in businesses, rather than certificates to trade on daily or quarterly emotional whim. It also involves only buying businesses that can be purchased for fair value or less. Many of history's most successful investors have followed this investment approach over the past one hundred years. Furthermore, all of the companies our Group invests in have a demonstrated track record of successfully managing through a continuous stream of unprecedented crises. Our Group has the highest level of confidence in our investment process, and would never consider selling an investment as a result of market pessimism, regardless of how bad that pessimism becomes[4].

A final factor that contributed to the average investor losing twice as much money as the S&P 500 last year consisted of chasing after the most popular investments, and then panicking and selling when those investments tanked. While riding the coattails of investments that go up solely on the basis of momentum can feel great for a while, history has shown that it almost never ends well over the long-term. Over the past few years, fear of missing out led investors to flock to highflying tech companies such as Amazon.com and Netflix, which in many cases had lots of growth potential but not necessarily profit and cash flow potential. While the S&P 500 declined 7% last October, Amazon fell 20% and Netflix fell 19%. A crucial consideration is that the U.S. economy remained strong during last fall's stock market decline. What do you think will happen to overvalued growth companies when our economy actually experiences a recession? Last fall was just a preview of the damage such growth companies will experience. When an actual recession hits, the carnage from owning the most popular investments will be far worse[5].

History is full of other examples where the most popular investments led to steep investment losses. Warren Buffett gives the example of overenthusiasm for auto and airline companies in the past. These companies were the Amazon and Netflix of their era – the hot new technology companies that promised to transform the world. They had rapidly growing revenue. And they did transform the world. The problem is they ended up not making profits over the long term. Buffett cites overenthusiasm for auto and airline companies as a main reason why the Dow Jones index was flat from 1964 to 1981. Investors in the index saw no share price appreciation over a 17-year period. Similarly, the S&P 500 was flat from 2000 to 2013 as a result of overenthusiasm for technology companies. Over that thirteen year period, passive investors in the S&P 500 index saw no share price appreciation. How many investors have a retirement plan that allows for no return over thirteen to seventeen years[6]?

While last year ended with a dramatic decline of 20% for stocks from peak to bottom, the overall result for the full year was a more measured 4.38% decline. While the average investor realized a 9.42% loss, something far worse will happen in the future. There will be years when stocks fall 20% for the full year. It would not surprise us if the average investor lost twice that amount, or 40%, in a year like that. Our Group will continue to shun the crowd and follow an investment process designed to make sure our clients don't end up with that result[1].

Best Regards,

The Crescent Group
Carsten Frederiksen, CFP® | Paul Hendershot | Nick Weege | Andrew Ielmini | Lindsey Wood, MBA

Sources:

(1) DALBAR
(2) The Wall Street Journal
(3) JP Morgan
(4) The Einstein of Money
(5) S&P Down Jones Indices LLC
(6) Fortune

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