The Wealth Advisor

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The Unintended Consequences of Expected Outcomes

Investors today look to the latest economic data in an attempt to discern any information that might provide guidance on how to better position their investments for the risks ahead. The risks that many investors fail to consider, however, are risks that they themselves add to their own portfolios.

Investors, being human, are driven by very strong instincts when it comes to taking risks. Aside from having the benefit of opposable thumbs, humans, as a species, have climbed to the top of the food chain partially due to an incredible and innate ability to discern patterns. While many other animals can identify patterns, humans take it one step further and attempt to predict what will come next. This, unfortunately, can be a detriment to our perceptions of probabilities, as demonstrated by an experiment in which humans were asked to look at two randomly flashing lights, one green and one red.[1] Eighty percent of the time the green light was flashed. To predict which light would flash next, the best approach might be to always select green because you would be right 80 percent of the time. In this experiment, however, human participants underperformed pigeons and rats because they got caught up in trying to predict when the red light was going to flash next, even though they knew the probability of it doing so. Apparently, pigeons and rats are better at understanding probabilities than are people.

In other studies, two noted psychologists, Daniel Kahneman and Amos Tversky, showed that humans tend to be far from rational in how they make long-term predictions, relying on surprisingly short-term samples of data and/or data that are simply not relevant.[2] These findings have some very interesting implications for investors and risk.

Using Estimated Net Flows, a measure of how much money flowed into or out of open-end mutual funds, as an indication of the investment decisions made by individual investors, what we find over the past two years is absolutely staggering. As markets fell in 2008, investors rushed out of riskier assets, selling slightly less than $97 billion in domestic stock funds. As markets recovered in 2009, investors piled into the relative safety of bonds, buying a remarkable $284 billion in taxable bond funds and missing out on the significant returns posted by stocks. Needless to say, most investors fared poorly in predicting market outcomes and paid a significant price for doing so. Now consider the outcomes for investors who followed a disciplined and well-diversified investment approach. These investors experienced the negative market of 2008, as did the investors who abandoned or never had such an approach, but the well-diversified investors benefitted from the significant stock returns of 2009.

As investors, taking risk means betting on outcomes that will result from the decisions we make, even though we do not know for certain what those outcomes will be.[3] Unfortunately, as humans, we often find certainty where none exists and do not necessarily understand that we are actually adding risk to our portfolios. In the instance above, investors who followed their instincts did just the opposite of what the age-old investment adage of "buy low, sell high" indicates.

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While the risks investors add to their portfolios are most often measured in regret rather than dollars, this example shows that these risks can have very real consequences as to whether or not you achieve your financial goals.

The amount of information available to investors today is greater than ever in history. As such, so is the temptation to bet on a prediction about the future. So, the next time you feel the urge to abandon your well-diversified portfolio and your financial plan because of the latest reports on economic data, consider visiting with your financial advisor. We'll remind you that predicting the future is for the birds.

[1] Zweig, Jason. "Your Money and Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich." Simon & Schuster, 2007.
[2] Ibid.
[3] Bernstein, Peter L. "Against the Gods: The Remarkable Story of Risk." Wiley, 1998.

Gold Isn't Guaranteed

With all the recent media hype regarding the value of gold, it's important to remember that there is no such thing as a completely safe investment. Gold comes with no guarantees and can quickly lose its luster when investors truly understand how volatile gold prices can be. Consider the early 80s when gold traded at record highs as many speculators rushed into gold in response to the inflationary fears of the 1970s, but then the gold dropped more than 50 percent in value. Many of those speculators would have to wait more than 25 years for the price of gold to return to its 1980 peak.

While in measured amounts gold can provide diversification benefits to a portfolio, it should not be bought solely in response to inflationary fears or market concerns. Currently, gold is trading at or near a record-high price. Consider the fact that the price of gold is based primarily on supply and demand and can be highly volatile, consumers should be careful when investing in gold. After all, gold is a commodity, which is just another investment option.

Electronic Newsletter

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We would also like to take this opportunity to direct you to our new website: www.ProsperityConsult.com. We've spent the last few months updating the site to better represent the services we provide. Please let us know what you think.

Best Regards,
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