CLEARPOINT

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MICHAEL G. KUEBLER, ANALYST, RESEARCH

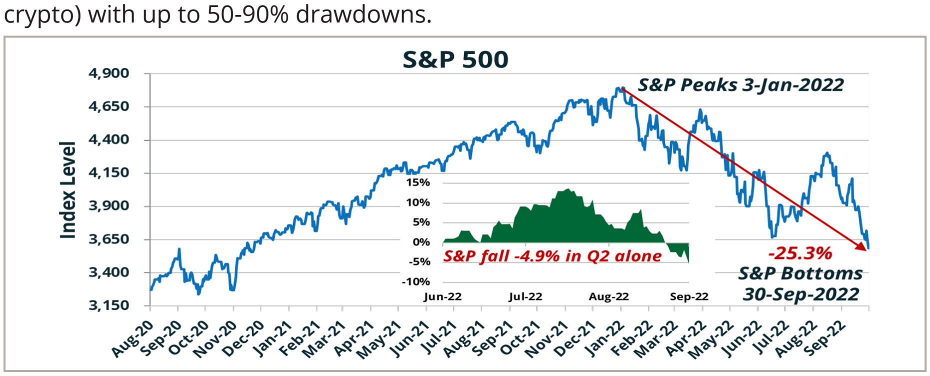
BEHAVIORAL FINANCE CAN CREATE CALM OUT OF DIFFICULT MARKETS

BY MICHAEL G. KUEBLER, ANALYST, RESEARCH

“Every past market crash looks like an opportunity, but every future market crash looks like a risk.”

So says investor and author Morgan Housel, who warns of the dangerous mindset that can overcome investors due to tendencies described by behavioral finance.

Financial markets in 2022 have tested investors’ emotions. Measures of negative performance and volatility are eye-opening: the S&P 500 Index was down -25.3% year-to-date at the end of the third quarter 2022,[1] and there is even deeper carnage in speculative areas of the market (unprofitable tech, meme stocks, crypto) with up to 50-90% drawdowns.



Source: Bloomberg. Data as of 9/30/2022. Past performance is not an indicator of future results. Investors cannot invest directly in an index; however, performance would be lower if Clearstead’s advisory fees were deducted.

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client team with Namita Naik.

Nimita joined Clearstead as a Client Planning Associate. She has a Masters of Commerce degree from the University of Mumbai and has completed her CFP. Prior to joining Clearstead, Nimita was a Relationship Manager at Huntington Bank.

These changes underscore the firm’s commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

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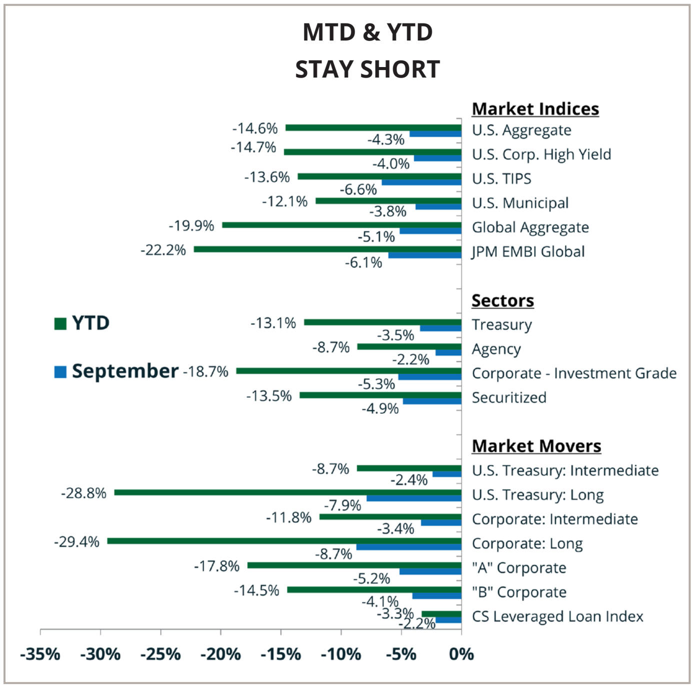
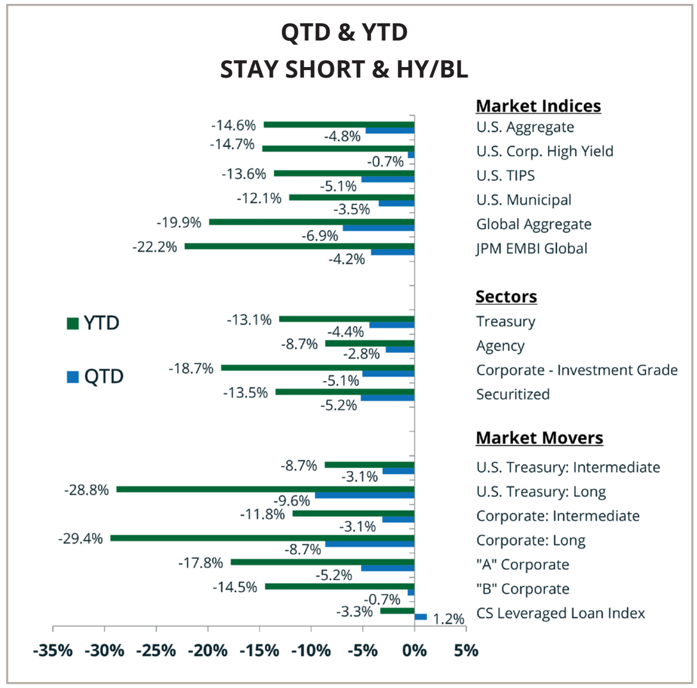
Making matters worse is that bonds—typically a counterpoint to equities—also experienced one of the worst periods in history as the US 10-yr Treasury topped 4%.[1] The sell-off in bonds is amplified by low yields over the past decade. Both the Barclays US Aggregate Bond and Barclays US Corporate High Yield indexes are down over -14% through the end of September.[1]

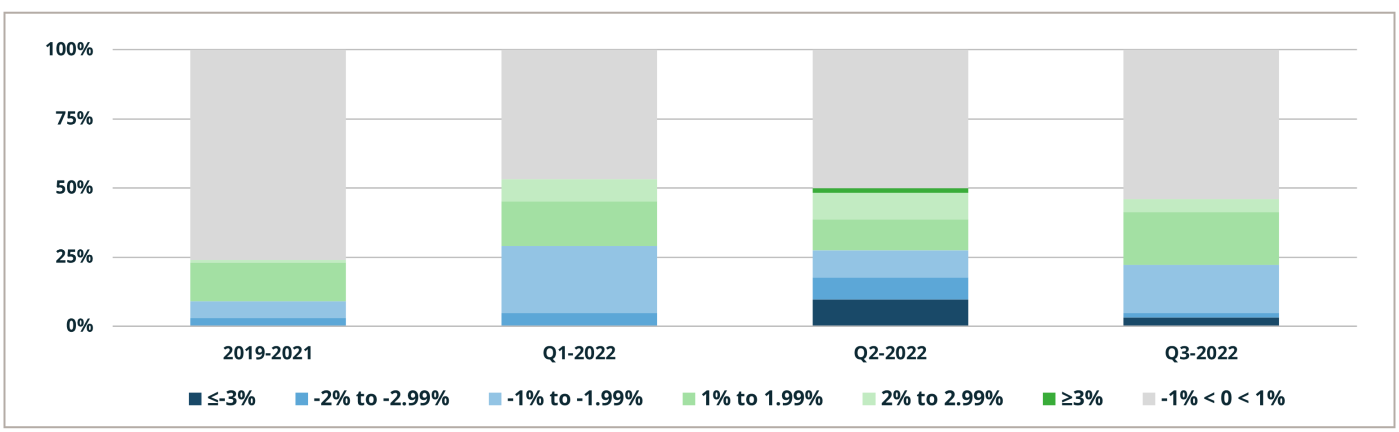




Source: Bloomberg. Data as of 9/30/2022. Past performance is not an indicator of future results. Investors cannot invest directly in an index; however, performance would be lower if Clearstead's advisory fees were deducted.

As with many bear markets, the year has seen fits and starts. Anyone tracking markets cannot help but feel whipsawed. Bear market rallies led to market lows in March, May, and June with each eventually surpassing previous lows before more new lows in October. Volatility has been high as the first three quarters of the year saw close to 50% of trading days with swings over 1% in either direction.

LARGE SWINGS HAVE DOMINATED THE S&P 500 INDEX IN 2022



Source: Bloomberg LP, Clearstead, S&P 500 Index daily data as of 9/30/2022. Past performance is not an indicator of future results. Investors cannot invest directly in an index; however, performance would be lower if Clearstead's advisory fees were deducted.

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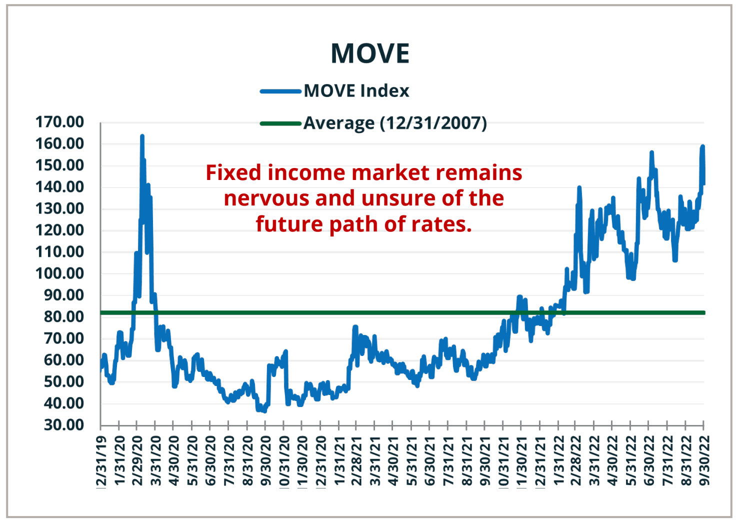
Bond market volatility has been even more pronounced with the MOVE Index (measure of U.S. interest rate volatility) touching levels seen in the early days of the COVID-19 pandemic. Interest rates are making daily moves that typically take months.



Source: Bloomberg LP daily data as of 9/30/22.

Markets are contending with inflation fueled by fiscal stimulus, easy monetary policies, supply chain disruptions, and other uneven supply/demand dynamics. Central banks' have responded to inflation by raising rates and restricting monetary conditions—increasing borrowing costs and driving asset valuations lower. Geopolitical uncertainty with the Ukraine War and China COVID lockdowns is another factor.

Something to remember is that the average investor (or even professional investor) does not know how events will unfold, much less the response in markets. Even economists usually do not get inflation and rate moves right. Geopolitical strategists can only guess at Putin's next move or what other global conflict might flare up and when. Even if one could predict the outcome of all the above factors correctly, determining the market's response is then next to impossible.

So, what are investors to do in this environment in which they have no control? The answer is to focus on the one thing that we do have control over: ourselves and our emotions. This is where behavioral finance comes into play.

WHAT IS BEHAVIORAL FINANCE?

Behavioral Finance studies psychological influences and biases of individual investors and markets. It is a subset of behavioral economics and stipulates that humans are beholden to emotions, and examines their impact on financial and investment decisions. As investors, it is beneficial to know that these concepts and biases exist, what they mean, and how we can counter them. Here are some common biases to be aware of:

- Confirmation bias is the tendency to favor information that confirms an already-held belief. For investors, this means seeking out information, interpreting data, or recalling history in ways that confirm one's opinion on a given investment and filtering out the rest. This can be dangerous as it avoids different views and leads to continued reliance on confirmatory information when, in fact, it may not be the reason for a given result.

- Loss aversion is a commonly cited human emotion. Humans tend to place more weight on avoiding losses than seeking gains. We inherently are risk averse, a bias that has been ingrained since early periods of human history when decisions were often a matter of survival. This bias can have varying effects when investing. A common pain point for investors is regretting selling winners too early to lock in a gain and holding onto losers in hopes of recovering from a loss. On the other hand, investors may also sell at the bottom thinking they need the pain of losses to stop. That loss aversion can result in both holding losers and selling losers may sound contradictory, but it is not that one or the other is right or wrong. The problem is that they are often done emotionally without consideration of actual fundamentals.

- Herd behavior refers to the human tendency to follow the crowd. This can be seen through rallies and crashes in markets or individual assets. It is most dramatically seen at tops and bottoms as buying begets more buying or selling leading to more selling.

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- Familiarity bias means investors tend to invest in what they know and with which they are comfortable. Examples are investors who only invest in domestic companies or a banker who only invests in bank stocks. The risk is they do not benefit from diversification and reduction of isolated risks.
- Self-attribution is having overconfidence and attaching too much credit to one's own skills. It manifests in the belief that good investments happen because of one's skill while bad investments are just bad luck.
- Recency bias is the tendency of recent events to lead one to believe they are far more likely to occur again than actual probabilities suggest. Succumbing to this bias as an investor in 2022 might have been painful, as the whipsawing of markets would have any trend-following investor chasing every rally and dip in the short term.

CONTROLLING YOUR EMOTIONS

While markets largely have been negative this year, opportunity awaits the patient investor who can control emotions and take advantage of the situation. History shows that forward returns are strong following drawdowns of the size that we have witnessed this year.

Corrections and bear markets in the S&P 500 Index have historically shown good buying opportunities

- Average return 1-year after a correction or a bear market = 32%
- Average return 2-years after a correction or a bear market = 45%
- Average return 3-years after a correction or a bear market = 56%

A bear market is defined as a decline in stock prices greater than -20%.

A correction is defined as a decline in stock prices of more than -10% but less than -20%.

Peak Date	Trough Date	Percent Loss	12-months later	24-months later	36-months later
2/13/1980	3/27/1980	-17%	38%	11%	48%
11/28/1980	8/12/1982	-27%	55%	50%	86%
10/10/1983	7/24/1984	-14%	32%	61%	108%
8/25/1987	12/4/1987	-34%	20%	54%	43%
1/2/1990	1/30/1990	-10%	4%	29%	35%
7/16/1990	10/11/1990	-20%	28%	41%	56%
10/7/1997	10/27/1997	-11%	23%	43%	56%
7/17/1998	8/31/1998	-19%	42%	57%	23%
7/16/1999	10/15/1999	-12%	12%	-14%	-35%
3/24/2000	10/9/2002	-49%	33%	43%	56%
11/27/2002	3/11/2003	-15%	44%	50%	61%
10/9/2007	3/9/2009	-57%	66%	96%	101%
4/23/2010	7/2/2010	-16%	25%	30%	60%
4/29/2011	10/3/2011	-19%	32%	55%	82%
5/21/2015	8/25/2015	-12%	17%	32%	53%
11/3/2015	2/11/2016	-13%	25%	54%	35%
1/26/2018	2/8/2018	-10%	6%	27%	43%
9/20/2018	12/24/2018	-20%	36%	55%	100%
2/19/2020	3/23/2020	-34%	75%	87%	?
1/3/2022	9/13/2022	-17%	?	?	?
Average		-21%	32%	45%	56%

Source: Clearstead, Ed Yardeni, Bloomberg LP, S&P 500 Price Return 1980-2022. Past performance is not an indicator of future results. Periods greater than 1-year are holding period return not annualized returns and are based on the period following the closing price of the trough date. Clearstead has selected the time periods shown of the S&P 500 Index to demonstrate how past correction periods have historically performed for illustrative purposes only and is making no representation that clients did or would have achieved the same performance. Investors cannot invest directly in an index; however, performance would be lower if Clearstead's advisory fees were deducted.

There are various tactics that an investor can take to use their knowledge of behavioral finance and better avoid the negative biases discussed here.

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Sometimes the best action is to do nothing. This can be in response to both negative and positive emotions. It can also relate equally to not selling and not buying. Recognizing that emotions are high during times of market volatility is important for avoiding irrational decisions. Making financial decisions under distress is a recipe for negative outcomes and regret later. Inaction can prevent bad decisions.

Many investors likely know of the concept of dollar cost averaging which means consistently buying investments at regular intervals to spread price risk over time. Dollar cost averaging trains one's investment muscles so that, during times of high emotions and stress, one is calm and does not change tactics.

Making decisions ahead of time—setting price targets for securities and buying them in down markets—also helps control emotions in the moment. It may not feel right to buy when the time comes but having pre-made decisions will eliminate the emotions of the moment.

For investors that qualify, private investments can help avoid negative biases of behavioral finance. Alternative investments vary from being fully illiquid to offering periodic liquidity. The more illiquid nature of these investments limits the decisions that investors can make; investors cannot emotionally buy and sell in and out of these funds as easily.

At Clearstead, we have a dedicated alternative investment research team finding high conviction managers and constructing private capital portfolios that we believe could help navigate volatile market cycles. Clearstead's advisors and portfolio managers can act as sounding boards during troubling times instead of falling prey to your own behavioral finance tendencies. Working with our advisors can help limit emotional biases.

Sources:
(1) Bloomberg.

MARKET BENCHMARK RETURNS

October 31, 2022		1M	3M	12M	YTD
US Large Cap	S&P 500	8.1%	-5.9%	-14.6%	-17.7%
US Small Cap	Russell 2000	11.0%	-1.7%	-18.5%	-16.9%
Developed Intl	MSCI EAFE	5.4%	-9.0%	-23.0%	-23.2%
Emerging Intl	MSCI Em Mkt	-3.1%	-14.1%	-31.0%	-29.4%
Real Estate	NAREIT	3.9%	-15.2%	-19.8%	-25.6%
Core Fixed	BarCap Agg	-1.3%	-8.2%	-15.7%	-15.7%
Short Fixed	BarCap 1-3Yr	-0.1%	-2.1%	-4.9%	-4.7%
Long Fixed	BarCap LT G/C	-3.8%	-15.6%	-31.3%	-31.6%
Corp Debt	BarCap Corp	-1.0%	-8.7%	-18.9%	-18.9%

Source: Bloomberg

The performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.