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Investors destined to repeat mistakes

Michael Nairne, Serious Money

If the definition of insanity is doing the same thing over and over again and expecting a different result, many investors seem to be a touch mad.

As the inevitable bull and bear market cycles occur, many investors routinely "buy high and sell low," yet wonder why their portfolio performance is poor.

Take 2009, for example. According to the Investment Funds Institute, Canadians yanked $6-billion out of equity mutual funds last year in a paroxysm of fear. Now, with the S&P/TSX up over 60% from its March 2009 low, Canadians are gingerly buying stocks again. Equity fund sales were slightly positive in RRSP season.

Any investor in equities should expect bear-market losses as the cost of accessing longer-term superior returns. The stock market is driven by the business cycle, the periodic but irregular fluctuations of output that are inherent to modern industrial society. These alternating periods of recovery, growth and recession are the normal rhythm of an economy. In the United States, there have been 32 cycles since 1854, about every five years on average.

You would think investors would have learned by now.

Industry experts have had a field day trying to measure the cost of this buy-high-and-sell low behaviour.

Recently, Morningstar estimated that over the past decade the average U.S. fund investor's returns lagged the returns of the funds in which they were invested by 1.5% a year, a cumulative shortfall of 16% in a decade that already featured dismal returns.

And the buy-high-and-sell low mentality extends beyond stocks. Investors' returns in municipal bonds underperformed the funds themselves by 1.61% a year. Bond funds were the hot seller in Canada last year -- just in time to face rising interest rates and subpar returns.

Some affluent Canadians exhibit the same pattern of emotionally driven investing, but in my experience, many avoid this ill-timed behaviour. There are several reasons for this. First, affluent investors tend to be older and have lived through the difficult markets of the 1970s and 1980s.

When you can recall the unsettling spectacle of cars lined up at U.S. gas stations during the 1973-74 oil embargo or the inexplicable crash on Black Monday in October 1987, when stocks dropped 22% in one day, bear markets become a little less terrifying. Stocks eventually recovered and the odds favour the same outcome in every tough market.

Affluent investors are also more likely to have a written financial plan. A recent survey of U.S. millionaires by the Phoenix Company found that 44% have financial plans. Notably, pentamillionaires (those with $5-million or more) were even more likely to have a written plan.

A good plan focuses on the long term and encourages steadfastness in the face of market volatility.

I have sat down with many a client during unsettling periods of market turmoil to review their investment plan and in almost every instance, the discussion has averted fearful selling and refocused attention on a sound long-term strategy.

Reason will prevail if given a chance.

Affluent investors also tend to be well diversified. The Capgemini World Wealth Report in 2009 found that high-net worth investors are invested in a range of assets including cash, fixed income, real estate, equity and alternative investments.

In 2007, just before the Great Meltdown, high-net worth investors had only 33% of their assets in equities.

If investors want a better result, they have to change their behaviour. A historic perspective, a written plan and sound diversification form the foundation for staying invested in turbulent times.

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