Focused on the Little Picture

Advisors need to help clients avoid 'recency bias' — the distortions that recent, well-publicized events can bring about in their thinking.

BY CRAIG ISRAELSEN and DARREN MORGAN

AS CLIENTS INVEST FOR RETIREMENT, EVEN THE most thoughtful may be impaired by 'recency bias.' This shows up in statements like, "How did my portfolio do last month?" or "Hey, the S&P 500 is averaging 20% for the past three years; why didn't my portfolio do that well?"

"Recency bias" is a state of mind where our views are most influenced by what we have experienced most recently. This colors our outlook and expectations of the future. The last book we read is the one we're most likely to talk about; the bad taxi ride we just experienced is the one we describe to others.

And, of course, recency bias clearly influences our views on investing. For example, from Jan 1, 1995, to Dec 31, 1999, the S&P 500 produced a five-year average annualized return of 28.6%. Investors in mutual funds that mimic the S&P 500 were awash with recency bias, inducing them to ignore a longer term trend: The average five-year annualized return of the S&P 500 since 1970 (as of Dec. 31, 1999) was 13.5%.

(By the way, as of Dec. 31, 2014, the average five-year annualized return for the S&P 500 was 10.6%. More on that later).

UNREALISTIC EXPECTATIONS

In late 1999, the cosmic expectations for the United States stock market were utterly unrealistic on the upside. But by the end of 2002, only three years later, the S&P 500 had plummeted and was now yielding a five-year annualized return of minus 0.58%.

In the process, unrealistically high expectations quickly became unrealistically low expectations — each based on recent experience.

Some investors bailed out of stocks by the end of 2002 with the mantra "I'll never let that happen to me again." By doing that, many clients were holding cash while the U.S. large-cap equity market experienced a five-year annualized return of nearly 13% between Jan. 1, 2003, and Dec. 31, 2007.

At some point, investors saw what was 'recently' happening and nudged themselves back into the U.S. equity market — only to get nailed again in 2008.

Once again, recency bias led them to bail out in the fall of 2008, only to miss out on the 17.2% average annualized return in the S&P 500 over the six-year period from Jan. 1, 2009, to Dec. 31, 2014.

TRAFFIC LIGHT FOR LEMMINGS

In short, recency bias generally acts like a broken traffic light for lemmings — directing them smack into the next accident.

The focus on short-run performance is as intense now as anytime previous, and fixating on performance over short time frames — such as one year — is highly symptomatic of recency bias.

For instance, when the S&P 500 returned over 32% in 2013, many clients bemoaned a "lack of performance" in their diversified portfolios — even though a typical 60% stock/40% bond portfolio returned over 18%.

Both recency bias (aka greed) and incorrect benchmarking (aka nonsense) led them to ignore the fact that their

current portfolio was designed for them on the basis of their answers to a risk tolerance questionnaire.

LET'S CALIBRATE

Recency bias is a near universal phenomenon shared by everyone to some extent. The only way to counteract the errors of judgment that it causes (expectations that are either overly optimistic or unduly pessimistic) is to cultivate an accurate understanding of the long-term performance of various asset classes.

To this end, the "Let's Calibrate" table below can be a very useful tool. It provides performance metrics for seven core asset classes over the past 45 years (1970-2014).

Now let's say a client is impressed by the recent performance of large cap U.S. equities. By the end of December 2014, the three-year average annualized return for the S&P 500 Index was 20.3%, using the SPDR S&P 500 ETF (SPY) as the investable proxy for the S&P 500.

This is very impressive, and the client may be tempted to load up on funds that mimic the S&P 500 Index.

THE LONG-TERM RECORD

But is it realistic to assume that this performance can continue at the recent rate? Referring to the table shows the client that the average three-year annualized return for the S&P 500 since 1970 has been only 10.8%. Any attempt to capture the more recent performance of the S&P 500 Index at

Recency bias tends to work against the most basic tenet of investing: buy low, sell high.

LET'S CALIBRATE

Performance metrics for seven core asset classes and a diversified portfolio over the past 45 years.

1970–2014	Large U.S. Equity	Small U.S. Equity	Non-U.S. Equity	U.S. Bonds	Cash	REITs	Commodities	Diversified 7-Asset Portfolio (equally weighted)
45-Year Average Annualized % Return	10.48	11.17	9.02	7.89	5.11	11.68	8.03	10.12
45-Year Std Dev of Annual Returns	17.43	21.87	22.19	6.57	3.45	19.27	24.93	10.18
Worst One-Year % Return	(37.00)	(33.79)	(43.38)	(2.92)	0.03	(39.20)	(46.49)	(27.61)
Worst Three-Year Cumulative % Return	(37.61)	(42.24)	(43.32)	6.15	0.17	(35.61)	(39.72)	(13.40)
Average 3-Year Annualized Return	10.83	12.23	10.14	7.93	5.26	12.38	9.66	10.45
Average 5-Year Annualized Return	10.55	12.30	9.66	8.03	5.38	12.31	8.87	10.45
Average 10-Year Annualized Return	11.21	12.69	10.18	8.24	5.64	12.91	8.65	10.88

The 45-year historical performance of large-cap U.S. equities is represented by the S&P 500, while the performance of small-cap U.S. equities is captured by using the Ibbotson Small Companies Index from 1970-1978 and the Russell 2000 Index from 1979-2014. The performance of non-U.S. equities is represented by the Morgan Stanley Capital International EAFE Index. U.S. bonds are represented by the Ibbotson Intermediate Term Bond Index from 1970-75 and the Barclays Capital Aggregate Bond Index from 1976-2014.

The historical performance of cash is represented by 3-month Treasury Bills. The performance of real estate is measured by using the annual returns of the NAREIT Index from 1970-1977 (annual returns for 1970 and 1971 were regression-based estimates since the NAREIT Index did not provide annual returns until 1972). From 1978-2014, the annual returns of the Dow Jones U.S. Select REIT Index are used (before April 2009, it was the Dow Jones Wilshire REIT Index). The historical performance of commodities is measured by the Goldman Sachs Commodities Index. As of Feb. 6, 2007, the GSCI became known as the S&P GSCI.

Source: Lipper, author calculations

nearly two times that rate is unrealistic and would reflect a clear case of recency bias.

Conversely, commodities were beaten up badly in 2014, and the S&P GSCI lost more than 33%. What's more, the three-year return for the GSCI Index between Jan 1, 2012, and Dec 31, 2014, was a grim minus 12.86%. Let's calibrate. The average three-year annualized return for commodities has been 9.66%. Based on recent performance, the case for recency bias against investing in commodities is quite probable.

Quite simply, recency bias tends to work against the most basic tenet of investing: buy low, sell high. Acting on the basis of recency bias and the fear that it induces generally leads to buying high, and then selling low.

HELPING CLIENTS REMEMBER

Near the market bottom in early 2009, clients who had previously scored as "balanced" on their questionnaires often chose to be "more conservative."

Conversely, given the current bull run in the U.S. equity market, clients with risk scores that positioned them in a balanced portfolio may now be clamoring for a more aggressive investment strategy. Diversified portfolios designed to deliver more stable, risk-reduced returns over time simply cannot keep up with a 100% stock index (such as the S&P 500) during an equity bull run.

The challenge is to keep clients focused on following their investment plan. The cause of their wanderlust is recency bias based on a very well publicized U.S. equity index: namely the S&P 500. When lesser known indexes are leading the way (such as the MSCI EAFE Index or a real estate index), clients tend to be less antsy because those indexes are less visible to them.

So is there a cure for recency bias? In short, no. Clients are humans, and humans are emotional creatures influenced by greed and fear. But absent a cure, information and logic may serve as a partial antidote.

FIVE IDEAS TO CONSIDER

It also helps to be systematic in your approach to advising clients. Here are five simple ideas to consider:

- A well-articulated investment philosophy is stabilizing when markets are wacky. Decide on a philosophy that is designed to meet each client's needs and expectations, and use it to guide the client's investment plan.
- Have the client write down his or her reasons for endorsing the investment plan. This document will be useful to review, should they want to change the plan on a whim that is clearly being driven by recency bias.
- Consistently implement the plan's rules and protocols. This may involve calendar-based rebalancing, using buy and sell signals to rebalance and so forth. In short, stick to the rules.
- Periodically review the plan with the client — not just when the client is being cranky about performance. It should be the plan that gets reviewed, not the performance. This can be an opportunity to review the client's earlier reasoning for choosing the plan, as well.
- Point out the perils of recency bias, and why it needs to be recognized when the performance of certain asset classes is either giddy or dismal. This discussion should be part of the periodic investment plan review. Remind clients that a diversified portfolio simply can't compete with hot performing individual asset classes in the short run.

Recency bias is detrimental if it incites a client to abandon a thoughtfully designed investment plan. Before bailing (for whatever reason), clients should be given a chance to see their behavior in light of recency bias.

If they are honest with themselves, they just might recognize the short-run cause of their discontent and remain within the safer confines of long-run logic-driven behavior. FP

A well-articulated investment philosophy is stabilizing when markets are wacky. Use this philosophy to guide the client's investment plan.

Craig L. Israelsen, a *Financial Planning* contributing writer in Springville, Utah, is an executive in residence in the personal financial planning program at the Woodbury School of Business at Utah Valley University. He is also the developer of the 7Twelve portfolio. **Darren Morgan** is an independent financial advisor to teachers, small business owners and retirees in North Olmstead, Ohio.