Behavior Gap

A MANUAL FOR SCARY MARKETS

It's perfectly normal to feel nervous in a scary market. It's part of being human.

Science has shown that we are genetically encoded to get more of the things that give us pleasure and to get away from things that cause us pain. In fact, a growing body of research in neuroeconomics shows that any thought or decision

involving profit is processed in the same part of the brain that we use to think about rewarding things, like chocolate. At the same time, when we experience or think about loss, it is processed in the same way as

when you are facing a physical or mortal danger. Jason Zweig puts it beautifully:

"There's not much difference in the brain between having a rattlesnake slither across your living room carpet and having some stock you own go down 40 or 50 percent. Basically it's the same response, which is, 'I'm in trouble; how do I get out of here alive?'"

So let's get this out of the way: It is OK to feel nervous during scary markets, but it is NOT OK to act on the fear.

Very rarely can we change a genetic trait by throwing facts and figures at it. Furthermore, this is an emotional issue! It makes perfect emotional sense to sell out of a market when it is down—it's a scary time and our first instinct is to run. But it makes no logical sense, as you'll soon discover.

Given that most of us have this genetic trait, the key is to figure out a way to "trick" ourselves into behaving correctly. Doing so involves addressing both the logical and the emotional side of this problem. We can address the logic by understanding scary markets of the past; how they started, how they ended, and how in every case, they were a lot less scary when one behaved correctly.

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But knowing what to do during a scary market and actually doing it are two entirely different things. Most of the time, our emotions take over and lead us down the emotional path. The problem is that these emotional behaviors make us feel like we're doing the right thing—we're avoiding pain after all—so they actually feel quite rational. And that's where it gets so confusing. You have to understand that most of us have this genetic trait to act in ways that help us avoid pain, but it can cause serious financial damage. As you will soon see, the investing public makes HUGE mistakes by acting at exactly the wrong time.

So what are the tricks to keep us from acting on our fears?

First, you need to understand how these markets work, and understand the history surrounding some of the scariest. Then, unless you see Warren Buffet in the mirror, you will probably need some help. I realize that this is going to sound self-serving, but I am convinced that for the vast majority of us, there is only one way to solve this problem: hire a Family CFO. Even with a great understanding of what is really happening in the market, every three to five years the "perfect storm" of events comes along and tempts us to make the BIG mistake that logically we know we shouldn't make. But remember that knowing the right thing to do and actually doing it are totally different.

Having someone there to walk you in off the ledge is worth its weight in gold.

AN HISTORICAL PERSPECTIVE

Believe it or not, some of the scariest markets we've been through actually weren't that bad if you didn't give into the emotional, human behavior and sell out. Instead, if you tricked yourself into doing the correct thing, staying put and not acting at all, you would have come through those markets just fine. Let's look at three of them.

For historical perspective, I've picked a decline of about 20% for what constitutes a scary market. Since World War II, there have been 13, including the one we're in right now. That means, on average, one scary market every five years. I've picked three of the biggest, scariest markets we've been through—which were scary for different reasons. I want you to understand what would have happened if you invested in a diversified portfolio of stock mutual funds on January 1 of the year that particular market started, and then didn't do anything with it for five years.

The scary market of 1973-74.
This scary market lasted 694 days, top to bottom. On January 11, 1973, the market hit its high, and then began a long and painful downturn that lasted 23 months. When the market had lost 45%, most people finally gave into the fear and sold—at rock

bottom. But, if you invested your money at the absolute high (usually a bad idea), and then did absolutely nothing with your money the next five years, you would have made 7.9%. Not so bad, huh? Understand that during the middle of those five years, you would have been down 45%. But if you had been blissfully unaware of that fact, or wonderfully capable of ignoring it, you would have come out on top.

The infamous Black Monday.
Let's move on to October of 1987. In some ways, I hate to even include this market, because it was so short. This entire scary market lasted just 101 days, and really, the whole focus is on a single day. But since it has its own name attached to it—Black Monday—I have to bring it up. Let's say you were able to ignore your investments during all of the commotion going on in September, October and November of 1987. Especially in October. You would have been up 5.2% at the end of that one year, and up 14.2% at the end of the next five years. But chances are, you didn't ignore it. You probably panicked like the rest of the nation, and sold at the worst possible time, when the market was down 33%. No wonder it seems so scary.

929 scary days.
And finally, let's look at the infamous tech bubble of 2002. Or more accurately, the 2000-02 bear market. Now this is the longest scary

market we've endured since World War II, lasting an excruciating 929 days. And since it's the most recent, it's also the most painful. By 1999, playing the stock market had become America's favorite pastime. Jump ahead to 2000, when the market had gained 86% during the last three years. In January of that year, net inflows to the market shot up to $44.5 billion. In February, the shortest month of the year, inflows hit $55.6 billion. That's almost $2 billion a day! And in March, investors poured another $39.9 billion into the market. All when the market was at a record high.

But investors paid dearly for their irrational exuberance. March 24, 2000, marked the peak for this particular cycle. After that, things went downhill. By October 10, 2002, the market had lost 50% of its value. With the market down over 50%, people continued to sell. October marked the fifth month in a row that investors pulled more money out of stock mutual funds than they invested. That had never happened before. I repeat. Never. At the market low, instead of buying equities at the best "sale" prices in five years, investors moved their money

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into bond funds, making the classic mistake of having bought high and sold low. Bond funds experienced a record inflow of $140 billion in 2002. At the time, bond funds were at a 46-year HIGH.

See a pattern here? Investors get scared, give into the fear, and sell at the worst possible times, over and over again.

However, if you simply held onto your investments during the scary market of 2000-02, and held them for the five year period ending in 2004, you would have made 8.9%.

BECOMING BLISSFULLY UNAWARE

What each of these examples points out is that even during the scariest markets, it's possible to come through unscathed. If you behave correctly. Which means not doing anything! But as I said before, that's really hard to do. Some people are born with the ability to do it, but the vast majority of us need help.

Yet the financial services industry is ill-equipped to help us. I know that sounds crazy, but they're often part of the problem. A traditional stock broker or industry

salesperson can be driven by commissions based on selling you products and services you don't really need, so they're not inclined to sit back and tell you to do nothing.

What you need is someone who can help you stay objective. Someone with the emotional distance to help you make smart decisions about your money, and act as your behavior coach during scary times. You have to understand that investment success isn't about skill. It's about behavior.

I believe the answer is simple. Hire a Family Chief Financial Officer (Family CFO) whom you trust completely, and have him be the cornerstone of your Wealth Management Team.

THE FAMILY CFO

A Wealth Management Team consists of all the financial advisors in your life, from your attorney to your CPA. Using a holistic approach, the Family CFO compiles your team's expertise and implements action based on their advice and his experience, focusing on your long-term wealth management plan. A Family CFO doesn't face the same conflict of interest as a stock broker. In fact, the best Family CFOs are paid a predetermined rate and receive compensation from only one source: you. There are no hidden strings, no lurking fees. You control your financial relationship.

A good Family CFO is hard to find. Their value comes not from finding great investments, but from creating great investors.

For the Family CFO, it's about the relationship and understanding what you need from your investments. Maybe it's more free time with your family, saving for education funds, or ensuring your retirement. Whatever your goals, a Family CFO will help make it happen. You remain your family's CEO, making the big decisions. Your Family CFO helps make sure you're making the right ones.

Of course, you need to have a financial plan in place, using a great investment process. That's a big part of the job. But the predominant part of your Family CFO's job is to help you avoid the big behavioral mistakes. Yes, I did use the word predominant. All the other stuff we do together pales in comparison to this. Often, your Family CFO is there simply to keep you from acting on emotional fears. I often joke that I could have a message on my answering machine saying, "Don't do that!" I know it's hard. You might be the rare person who can go it alone, but for 99% of us, we need someone there to help us. Someone to keep us from making the classic investment behavioral mistakes.

If you'd like to learn more about this idea, which I call the Behavior Gap™, I invite you to join the conversation at behaviorgap.com. You'll find more information about what drives typical investment behavior and how to make the Family CFO relationship work for you. These are scary times. We could all use someone to help us through them.

ABOUT THE BEHAVIOR GAP

For years, a guy named Carl noticed something interesting: The real-life return of the AVERAGE INVESTOR was dramatically lower than the return of the AVERAGE MUTUAL FUND. In theory, this gap shouldn't exist, but investors were leaving money on the table and didn't seem to understand how it happened.

Carl named this phenomenon the Behavior Gap™. For over 15 years, Carl's relentless curiosity has driven him to explore why the Behavior Gap exists and to share what he knows about it. Carl's main purpose for creating the Behavior Gap is to help people close the gap by learning and practicing the best investor behavior. Carl shares his findings via behaviorgap.com and at public speaking engagements.

ABOUT CARL RICHARDS

So who is Carl? After more than ten years working in the brokerage industry, Carl went out on his own to serve as the Family Chief Financial Officer (CFO) for a select group of families. In addition to his role as Family CFO, Carl also serves in a research capacity for multiple financial firms with offices in Arizona, Nevada, North Carolina, Georgia, and Utah.

Carl received a Bachelor of Science degree in Finance from the University of Utah, and he's credentialed as a Certified Financial Planner™. Married with four children, Carl enjoys spending time outside with his family. If you want to learn more about the Behavior Gap™, feel free to email him at carl@behaviorgap.com.

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