Calm, Steady and Common Sense Series

Using Emotion as Your Investment Guide Could Cost You White Paper

The **Calm, Steady & Common Sense Series** explores how using emotion as your investment guide could cost you return on your investments.

The **Using Emotion as Your Investment Guide Could Cost You** white paper discusses the 25th edition of the Qualitative Analysis of Investor Behavior, which is a report by the consulting firm, Dalbar, that illustrates the danger of mixing emotions with investing.

While no two markets are the same and past performance is never an indication of future results, historical evidence suggests that using emotion as your investment guide could cost you dearly.

Emotions and the stock market may be as detrimental to each other as the Red Sox and the Yankees playing against each other in September while in the middle of a tight pennant race.

Dalbar, a Boston-based consulting firm, released their 25th edition of the *Qualitative Analysis of Investor Behavior*, which illustrates the danger of mixing emotions with investing. Their study measures the effect of investor decisions to buy, sell and switch in and out of mutual funds over short and long-term periods.

Generally, over the 25 years that Dalbar has conducted this analysis, they have shown how the average investor has consistently earned less - in many cases significantly less - than the performance of the funds they own. Dalbar will point to investor's movements in and out of their funds when markets move up or down as the primary culprit.

Dalbar analyzes the timing of investments into funds and redemptions out of funds. Their research suggests that most money moves into funds when the markets hit highs and leaves after the market has significantly pulled back. This emotion-based investing seems to create the classic buy high/sell low scenario, which may be a sure way to decrease your return.

When viewing the stock market's long-term return, Dalbar exposed a pattern among investors. Through the 20-year period ended December 31, 2018, the S&P 500 returned an average of 5.62% per year compared with the -7.41% average annual return of stock fund investors who moved in and out of their funds.

This suggests that a hypothetical $100,000 in an investment that was able to generate the returns of the S&P 500 for this 20-year period would have grown to $398,450 provided the investor stayed fully invested and did not move in and out of the market each time stocks hit a new high or sold as the market hit lows.

However, according to Dalbar, for those who might have used emotion as their investment guide, their $100,000 would have grown to $121,440, a significant $277,010 less for every $100,000 invested* compared to the investor who stayed invested.

Clearly, mutual fund returns and expenses compared to the index play a role, but Dalbar believes that gaps of this size result primarily from ill-fated buy and sell decisions. In a previous edition, they say that they have learned that the greatest losses occur after market declines. They say that investors tend to sell out of their funds when the market declines and will not begin investing again until the stock market has regained the value it lost.

Dalbar goes on to say, "The devastating result of this behavior is the participation of the downside while being out of the market during the rise". As previously mentioned, this appears to be a classic example of investors buying high and then selling low, which suggests that there would be difficulty in achieving comparable returns to the stock market.

Dalbar also stated, in a previous edition, that the worst gap occurred in October 2008 when the S&P 500 lost 16.8% but investors lost 24.21%, leaving a gap of -7.41 points in only a one month period.

In periods of market declines it may be prudent to understand the historic significance of the Dalbar study and think twice before you use emotion as your investment guide.

**This hypothetical example does not take into account the effect of taxation.*

Disclosures

Investments are subject to risks, including possible loss of principal. Investors should consider the investment objectives, risk factors and expenses of any investment carefully before investing. Diversification does not guarantee profit or ensure against loss.

The S&P 500, or the Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 Index components and their weightings are determined by S&P Dow Jones Indices. It differs from other U.S. stock market indices, such as the Dow Jones Industrial Average or the Nasdaq Composite index, because of its diverse constituency and weighting methodology. It is one of the most commonly followed equity indices, and many consider it one of the best representations of the U.S. stock market, and a bellwether for the U.S. economy. You cannot invest directly in an index.

All examples are hypothetical and are for illustrative purposes only. We encourage you to seek personalized advice from qualified professionals regarding all personal finance issues. The solution for an investor depends on their and their family's unique circumstances and objectives.

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