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Investing is an activity that seems to be all about numbers. People want to know what the price/earning ratio of a stock is. They prefer it to be low. They want to know what a bond yields. They prefer that to be high. Going deeper, we can see the average annual compound rate of return, noted as AACROR, of portfolios and mutual funds in which we are interested. And more complex calculations, like the standard deviation of those returns, give a clue as to how much the return may vary from its average in a single year. All of this lends credibility to managers who understand and use these measurements. But the past year has reminded us of something more important. Financial markets can be measured mathematically, but those markets are majorly about human behavior; not numbers.

The “standard deviation” I mentioned provides an example of this point. The technical explanation of standard deviation is that 95% of the time you can expect the return of a portfolio for a year to fall within plus or minus two standard deviations of its average return (the AACROR). In plain English that means this will occur in 19 out of 20 years. You are probably asking, “What about that 20th year?” The answer is, that’s what we’ve just seen. Last year stocks dropped 35% to over 40%. Most of this came in the last half of 2008. There is no assurance that we will soon return to this very clean mathematical model. That’s because the market is so very much about human behavior and not mathematics. But this does not mean all is lost.

I have often noted that if you look at long-term market statistics you see that stocks produce about twice the return of bonds. This always raises the question, why bother with bonds? The answer is, again, human behavior. I have noted in my career that people who lived through the Great Depression were likely to be highly afraid of investing in stocks. If I ever suggested stocks to them, the reaction was a five-minute diatribe and then we reverted to bonds.

Younger investors typically have a different point of view. They tend to be aware of the strong regulations that were imposed after the Depression which greatly improved investing. But they also are aware of periods like the early ‘70s when in two years stocks fell about 50%. The result of their grasp of history is that investing in stocks can help, but they insist on including bonds in their portfolio. Even though bonds produce lower returns, they significantly lower the risk of their total portfolio.

Such portfolios, mixtures of stocks and bonds, still suffered last year. But, while stocks declined 35% to 40% in 2008, these mixed portfolios typically fell less than half of the average 100% stock portfolio. The effect of this on the behavior of these investors is striking. They are generally able to control their emotions. They may pare back on stocks a bit, but because they have not been decimated they are willing to hang onto their portfolio. After the first weeks of March they were breathing a bit easier, even though we are not out of the woods.

The lessons here are eloquent. Investing is mostly about human behavior. Don’t invest in things you cannot understand. Always remember that there is risk in any portfolio. Stocks can produce high returns, but there are surprises always lurking. And try your best to build a portfolio that fits your tolerance for risk. You very probably won’t get wealthy from investing, but over time you can do better than treasury bills and CDs. Try your best to build a portfolio that will allow you to sleep every night.