Recency Bias in Investing

Something to Avoid

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TRADITIONAL ECONOMIC THEORY held to the concept that investors act rationally, that we make rational choices in our effort to maximize profitability and achieve our investment goals. Then in the 1970s and '80s, an emerging study rooted in psychology, "behavioral finance," revealed more about how investors actually make financial decisions. It's probably not surprising that researchers discovered that humans are not always rational. We tend to make decisions based on emotion and cognitive biases, one of which is "recency bias," whereby we rely heavily on recent events, experiences that are fresh in our minds, to make choices. It seems we are hardwired to do so; our brains are designed to access and prefer the most available information instead of doing the hard work of analyzing long periods of the past. We'll pull from the quickest information available to make the quickest decisions.

For investors, recency bias leads to decisions based on short-term rather than long-term performance. It encourages investors to chase market trends. We'll identify an asset class that has performed well recently and assume that performance will continue. The result is that the investor buys assets at their peaks, their highest prices. It can also result in an investor putting all, or at least too much, of their assets into a single stock or asset class instead of diversifying.

Consider that in 2019 financial services was one of the best performing sectors in the S&P 500 Index, delivering an annual return of 32 percent. In 2020, that sector returned -2 percent, while the S&P 500 Index returned more than 18 percent.

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Asset Class Returns

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD
HG Bnd 5.2%	EM 79.0%	REIT 28.0%	REIT 8.3%	REIT 19.7%	Sm Cap 38.8%	REIT 28.0%	REIT 2.8%	Sm Cap 21.3%	EM 37.8%	Cash 1.8%	Lg Cap 31.5%	Sm Cap 20.0%	REIT 41.3%	Cash 1.6%	Int'l 8.6%
Cash 1.7%	HY Bnd 57.5%	Sm Cap 26.9%	HG Bnd 7.8%	EM 18.6%	Lg Cap 32.4%	Lg Cap 13.7%	Lg Cap 1.4%	HY Bnd 17.5%	Int'l 25.6%	HG Bnd 0.0%	REIT 28.7%	EM 18.7%	Lg Cap 28.7%	HY Bnd -11.2%	Lg Cap 7.5%
AA -22.4%	Int'l Stk 32.5%	EM 19.2%	HY Bnd 4.4%	Int'l Stk 17.9%	Int'l Stk 23.3%	AA 6.9%	HG Bnd 0.6%	Lg Cap 12.0%	Lg Cap 21.8%	HY Bnd -2.3%	Sm Cap 25.5%	Lg Cap 18.4%	Sm Cap 14.8%	HG Bnd -13.0%	AA 4.5%
HY Bnd -26.4%	REIT 28.0%	HY Bnd 15.2%	Lg Cap 2.1%	Sm Cap 16.4%	AA 11.5%	HG Bnd 6.0%	Cash 0.0%	EM 11.6%	Sm Cap 14.7%	REIT -4.0%	Int'l Stk 22.7%	AA 9.8%	Int'l Stk 11.8%	Int'l Stk -14.0%	EM 4.0%
Sm Cap -33.8%	Sm Cap 27.2%	Lg Cap 15.1%	AA 0.3%	Lg Cap 16.0%	HY Bnd 7.4%	Sm Cap 4.9%	Int'l Stk -0.4%	REIT 8.6%	AA 14.6%	Lg Cap -4.4%	AA 18.9%	Int'l Stk 8.3%	AA 10.9%	AA -16.5%	HY Bnd 3.7%
Lg Cap -37.0%	Lg Cap 26.5%	AA 13.5%	Cash 0.1%	HY Bnd 15.6%	REIT 2.9%	HY Bnd 2.5%	AA -1.3%	AA 7.2%	REIT 8.7%	AA -5.6%	EM 18.9%	HY Bnd 7.5%	HY Bnd 5.4%	Lg Cap -18.1%	HG Bnd 3.0%
REIT -37.7%	AA 24.6%	Int'l Stk 8.2%	Sm Cap -4.2%	AA 12.2%	Cash 0.1%	Cash 0.0%	Sm Cap -4.4%	HG Bnd 2.7%	HY Bnd 7.5%	Sm Cap -11.0%	HY Bnd 14.4%	HG Bnd 6.1%	Cash 0.0%	EM -19.7%	Sm Cap 2.7%
Int'l Stk -43.1%	HG Bnd 5.9%	HG Bnd 6.5%	Int'l Stk -11.7%	HG Bnd 4.2%	HG Bnd -2.0%	EM -1.8%	HY Bnd -4.6%	Int'l Stk 1.5%	HG Bnd 3.5%	Int'l Stk -13.4%	HG Bnd 8.7%	Cash 0.6%	HG Bnd -1.5%	Sm Cap -20.4%	REIT 1.7%
EM -53.2%	Cash 0.1%	Cash 0.1%	EM -18.2%	Cash 0.1%	EM -2.3%	Int'l Stk -4.5%	EM -14.6%	Cash 0.3%	Cash 0.8%	EM -14.3%	Cash 2.2%	REIT -5.1%	EM -2.2%	REIT -25.0%	Cash 1.1%

Source: https://novelinvestor.com; NovelInvestor.com

ABBR.	ASSET CLASS – INDEX	ANNUAL	BEST	WORST
Lg Cap	Large Cap Stocks – S&P 500 Index	8.81%	32.40%	-37.00%
Sm Cap	Small Cap Stocks – Russell 2000 Index	7.16%	38.80%	-33.80%
Int'l Stk	International Development Stocks – MSCI EAFE Index	2.29%	32.50%	-43.10%
EM	EM Stocks – MSCI Emerging Markets Index	0.99%	79.00%	-53.20%
REIT	REITs – FTSE NAREIT All Equity Index	6.64%	41.30%	-37.70%
HG Bnd	High Grade Bonds – Bloomberg Barclays U.S. Agg Index	2.57%	8.70%	-13.01%
HY Bnd	High Yield Bonds – ICE BofA US High Yield Index	6.02%	57.50%	-26.40%
Cash	Cash – S&P U.S. Treasury Bill 0-3 Mth Index	0.62%	1.66%	0.00%
AA	Asset Allocation Portfolio*	4.87%	24.60%	-22.40%

Source: https://novelinvestor.com; NovelInvestor.com

Past performance does not guarantee future returns. The historical performance shows changes in market trends across several asset classes over the past 15 years. Returns represent total annual returns (reinvestment of all distributions) and does not include fees and expenses. The investments you choose should reflect your financial goals and risk tolerance. For assistance, talk to a financial professional. All data are as of 3/31/23.

*Asset Allocation Portfolio is 15% large cap stocks, 15% international stocks, 10% small cap stocks, 10% emerging markets stocks, 10% REITs, 40% high-grade bonds, and annual rebalancing.

The performance of each asset class in comparison to others over the years demonstrates how performance of a particular class varies from year to year. Hence the cautionary warning: "Past performance is no guarantee of future returns."

FOMO

Recency bias can be exacerbated by a fear of missing out (FOMO). As opposed to considering the underlying value of a stock or investment, the investor buys it or avoids it because others are. That can result in buying at the highest price, or not buying when the investment is at a discount. We're reminded of the movie JAWS, how many people avoided the water that year despite 50 years of history of the slightest chance that you would see much less get bit by a shark.

An essential role of your advisor is to design a target asset mix that supports your financial goals, risk tolerance, and time horizon. The percentages of the mix are not stagnant as the values of the difference asset classes grow and change over time, so your advisor restores your target asset allocation by routinely rebalancing your portfolio.

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For example: A portfolio is designed for a 40 percent allocation of U.S. large-cap stocks. Over time the value of those stocks grows to 55 percent of the portfolio value. If left unchecked this increased weighting to equities alters the risk profile of the portfolio. The advisor trims 15 percent of U.S. large-cap stocks gains, then buys something out of favor, something undervalued, thereby rebalancing the portfolio to its proper allocation with investments priced at a discount.

It's a common theme of Warren Buffet's, that investors should be "fearful when others are greedy, and greedy when others are fearful." That contrarian view on stock markets relates directly to the price of an asset. When others are greedy, prices typically boil over, and you could overpay for an asset that subsequently leads to anemic returns. When others are fearful, that could translate to a high-value opportunity.

As financial advisors, we want our clients to stick to their financial plans, sound financial plans that target long-term goals, part of those plans being reallocation. In our meetings with our investor clients, we focus on long-term performance of their assets as a way to negate recency and other biases. Of course, people can be concerned, or fearful, when markets are down, but we ask our clients to hold off on rash decisions. As the much quoted Benjamin Graham, the so-called "Dean of Wall Street," noted, "The investor's chief problem — and even his worst enemy — is likely to be himself."

MARKETS ARE CYCLICAL

Your plan shouldn't change based on a current event. The market works in cycles, and it's important not to act on fear or greed, selling in a down market or chasing yesterday's winners. Recency bias clouds our judgment and can derail us from our financial goals.

Instead, investors should think long-term. Stay connected with your financial advisor, reviewing your plan regularly to stay on course toward your long-term goals. Consider an investment, whether you're buying a business or a stock, as something you see yourself holding for 10 years. It's the difference between investing and speculating.

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