

# the EDUCATED INVESTOR

FEATURE ARTICLE

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## A Perfect Storm

**Overview:** Investors are faced with a perfect storm of information overload, human emotions and market volatility. Following is a discussion of those threats to investors' portfolios and a way to avoid the storm.

### Information and Technology

If you do a search on Google for the word "investing", you will get 69 million hits in 0.23 seconds. If you visit one of numerous financial Web sites, you can read the blogs of experts who share their opinions and recommendations every day or so. If you have satellite radio, you can listen to CNBC almost anywhere in the world.

It has never been easier for investors to trade frequently, and for what they think is cheaply, based on the information all these media outlets provide. With smart phones, not only can investors access information anywhere, they can act quickly on all that information with a single text. Stocks, bonds and mutual funds can be traded from anywhere in the world at any time.

All of this technology and information should make it easier for investors to make smarter decisions, right?

Wrong! The constant flow of information and the advent of handheld portable devices that allow investors to act instantly on their reaction to information can be hazardous for the nation's wealth.

### Stocks in the Media

The 2008 study "All That Glitters: The Effect of Attention and News on the Buying Behavior of Individual and Institutional Investors" by Brad Barber and Terrance Odean found that individual investors buy attention-grabbing stocks, meaning "stocks in the news, stocks experiencing high abnormal trading volume and stocks with extreme one-day returns." Because investors have so many stocks to potentially buy, many investors consider purchasing only the stocks that have caught their attention.

The authors found that the attention-driven buying patterns they documented "do not generate superior returns." In fact, they concluded that "most investors will benefit from a strategy of buying and holding a well-diversified portfolio."

With the media constantly stirring up emotions, telling investors all the good reasons why they should get in or out of the market, remember the following from legendary investor Warren Buffett: “We’ve long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie (Munger) and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.”

### **Fear and Greed**

Many investment mistakes that smart people make are based on two human emotions: fear and greed.

One of the most important golden rules of investing is to buy low and sell high. When human emotions take control, it becomes difficult to follow that simple rule. Investors watch a stock or an index go up and up and up, and greed kicks in. Investors tend to buy after the great return has already happened. Then, investors watch that investment go down to a point where they can’t take it anymore. They decide to sell.

In other words, investors buy funds after they have had good performance (out of greed) and then sell their funds after they have had bad performance (out of fear). They miss most of the gains and then lock in their losses. When you add market volatility to investors’ fear, greed and information overload, you have a disaster waiting to happen.

Here’s an example. Let’s say that an investor had \$100,000 invested in the stocks that compose the Dow Jones industrial average on February 28, 2009. Hearing media predictions that the Dow would fall to 5000, the investor panicked and took his money out of the market on March 1, 2009, and bought one-month U.S. Treasury bills. In this scenario, the investor would have had a return of \$82.69 on his \$100,000 at the end of the year.

However, if the investor had not acted on fear and had stayed in the market, he would have seen his \$100,000 stock portfolio grow to more than \$151,000 by December 31, 2009. That’s a costly mistake of \$50,000, or 50 percent of this investor’s portfolio.

Jason Zweig, investing and personal-finance columnist for *The Wall Street Journal*, gave investors this advice: “Making a financial decision while you’re inflamed by the prospects of a big gain, or a huge paper loss, is a terrible idea. Calm yourself down — if you don’t have kids to distract you, take a walk around the block or go to the gym — and reconsider when the heat of the moment has passed.”

### **The Value of an Investment Advisor**

A good advisor will help investors stick to their plan despite the human emotions that are triggered by the noise in the media and the volatility in the markets. That plan should be built for the long term based on an investor’s goals and values.

How can investors avoid being caught up in this perfect storm? Zweig’s advice to investors would be to remain resolute: “Successful investing is about controlling the controllable. You can’t control what the market does, but you can control what you do in response. In the long run, your returns depend less on whether you pick good investments than on whether you are a good investor.”

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