Morgan Stanley

Philip W. McCauley III, CFA®
The Madison Group
Managing Director, Wealth Management
Senior Portfolio Management Director
Financial Advisor

Wealth Management
4969 US Highway 42
Suite 1200
Louisville, KY 40222

direct 502 394 4034
fax 502 434 6467
toll free 800 626 1592

NMLS # 1255533
philip.mccauley@morganstanley.com

This letter is dated March 2008

Price is what you pay. Value is what you get.
- Warren Buffett

A July 2007 study by Dalbar showed that from 1987 through 2006 stock funds averaged 11.3%.[1] This is not particularly surprising; after all, most investors have seen historical data showing that stocks have averaged better than 10% annually since 1926.[2] The remarkable number coming out of the Dalbar study was that while stock funds averaged 11.3%, stock fund investors averaged only 4.3% over the very same period. How can that be? How could investors in stock funds underperform the very asset class they are investing in—stock funds—so dramatically? The purpose of this letter is to discuss *myopic loss aversion*, a common driver of investor underperformance, and to offer thoughts on a way to potentially avoid this problem and its negative effects on performance.[3] This is a timely topic given the declines in stock prices that have occurred over the past several days, weeks and months.

Myopic loss aversion is a function of two phenomenons: loss aversion and short-term performance preoccupation. Loss aversion refers to the observation in behavioral finance studies that investors generally regret losses twice as much as they enjoy similar-sized gains.[4] Of course, two times is an average; some investors are more sensitive to losses while others are less. And naturally, the more concerned an investor is about performance the more often they tend to evaluate it. Since investors are typically more sensitive to losses, down markets tend to increase performance evaluation frequency and foster a focus on short term results. Evidence suggests this is true even for investors with long term—five, ten years and longer— time horizons.[5] Now, readers may ask, how can two ostensibly reasonable investor tendencies—loss aversion and short-term performance focus—be destructive to investment returns?

Consider the implications of loss aversion and frequent portfolio evaluation in light of the fact that the shorter the time period, the more likely stock performance will be negative. According to a recent analysis of stock returns and volatility, the probability of negative stock performance over a 12 month period is 28%. Shorten the period to one month and the

probability of loss jumps up to 44%. For daily periods the likelihood of a loss is nearly half—48.8% to be precise.[6]

These findings suggest that an investor with an average degree of loss aversion who evaluates portfolio performance too frequently is likely to get "worn out" over time. A simple example may help: think about an average loss aversion investor evaluating performance daily. Assume he starts with a zero balance in what we will call an "emotion account". Let's assume the first day is an up day so he gets a one unit addition to his account. Since, according to the study referenced above, any given day has a 51.2% probability of being positive it's reasonable to assume that every other day is positive in this hypothetical scenario. So day two is negative and two units are deducted from the investor's emotion account leaving a balance of negative one. As this scenario plays out over time, the investor's balance will fall further and further into negative territory until he is likely to become emotionally exhausted and driven to move his money into something else. The risk is that the investor abandons a well thought out plan, and either chases returns in a hot asset class that may be vulnerable to a big fall or retreats to a low volatility investment that may build less wealth in the long run.

This is not to suggest that performance evaluation is a bad thing but rather to point out that overly frequent performance measurement has the potential to be destructive. Investors that own stocks may experience a happier and more productive journey if they invest more time in studying the performance of the company they own—change in cash flow, management and competitive position for example— and less time tracking the share price. Stock fund owners may be better served by putting time and effort into evaluating their fund manager's investment strategy than they are by comparing short term performance numbers.

When one really thinks about it, following changes in prices alone makes very little sense. Suppose that an investor knows the price sequence of a particular asset that he owns— a rental house let's say. Assume that over the last three months the owner received one bid per month in the following amounts and order: $200,000; $190,000; and $175,000. What value does this price information offer to the owner? Should he sell now before the offers fall even further? I would suggest that this information alone is of little value because we do not know anything about changes in the value of the house over the same period. If the roof fell in or the tenant moved out the decline in offer prices may accurately reflect, or even under state, a

negative change in the value of the house. On the other hand, if a new roof was put on last week and the tenant just signed a long-term lease at a higher rental rate, the price decline may have nothing to do with the underlying value of the house.

In short, investors would likely improve their decision making and reduce their worries if they put more time into researching underlying value and less time into price watching. Furthermore, the potentially destructive effects of myopic loss aversion suggest investors may be better served by measuring price performance less frequently.[7] Admittedly, this is difficult in a world where stock price updates are fed to investors via television, computer and now even telephone. Certainly, information that offers insight into the value of a given asset is much more difficult to find than the most recent price quote on the asset. I suggest that investors check the price of a stock about as often as they evaluate the value of the underlying business. After all, prices are of little use without an understanding of value. This approach is certainly not common or easy, but it may involve less worry and lead to better results in the long run.

Phil McCauley III
March 2008

[1] Quantitative analysis of investor behavior by Dalbar, Inc. published in July 2007 and Lipper. Dalbar computed the "Average Stock Fund Investor" returns by using industry cash flow reports from the Investment Company Institute. The "Average Stock Fund Return" figures represent the average return for all funds listed in Lipper's U.S. Diversified Equity fund classification model.
[2] Ibbotson Associates
[3] Shlomo Bernartzi and Richard Thaler "Myopic Loss Aversion and the Equity Risk Premium Puzzle" *The Quarterly Journal of Economics*, February 1995, vol. 110 pp.73-92
[4] Amos Tversky and Daniel Kahneman first introduced the concept of loss aversion in the 1970's as part of a broader theory they called "Prospect Theory."
[5] Shlomo Bernartzi and Richard Thaler "Myopic Loss Aversion and the Equity Risk Premium Puzzle" *The Quarterly Journal of Economics*, February 1995, vol. 110 pp.73-92
[6] Michael Mauboussin *More Than You Know* New York: Columbia University Press, 2006, p.48
[7] Shlomo Bernartzi and Richard Thaler "Myopic Loss Aversion and the Equity Risk Premium Puzzle" *The Quarterly Journal of Economics*, February 1995, vol. 110 pp.73-92

This material was originally created on March 2008 and is provided for educational purposes only. The information is not current and should not be viewed or considered as investment advice or an investment strategy. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Morgan Stanley Wealth Management recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Past performance is no guarantee of future results

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

Morgan Stanley Smith Barney LLC. Member SIPC.

3961587 10/2024