

MARKET MONITOR

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INVESTOR BEHAVIOR AND THE FINANCIAL CRISIS: IS IT DIFFERENT THIS TIME?

Financial and economic shocks have hit investors hard, driving down the value of their portfolios over the past 18 months and causing many to question how they manage their long-term investments. Because no investor alive has experienced the size, scope, and rapidity of current market losses, it is understandable that people are wondering whether their responses should likewise depart from common practice. In other words, should investment management change to match the times?

- What does behavioral finance tell us about how investors could be reacting to economic and market distress?
- Which behavioral pitfalls should investors try to avoid?
- How can investors best ride out the current storm?



Over the past 20 years, behavioral economists have examined the ways in which investors behave and found a number of tendencies that can run counter to what investors were thought to do as a matter of course. These include some of the following dysfunctional behaviors:

OVERCONFIDENCE

Research has shown that, the more confident individual investors are in their ability to pick winning and losing funds and stocks, the more they trade. Further, investors who trade more often lose more money than investors who trade less often. Finally, men tend to be more confident in their investment abilities than women.

- **Underreaction, Overreaction and Paralysis.** These seemingly contradictory behaviors follow from some of the same motivations. Individuals tend to pay only intermittent attention to their investment portfolios. Within certain bounds, they tend to underreact to market movements, letting the market push around their asset allocations. However, when market movements are large and rapid, some investors either panic—moving all or most of their money to the safety of bonds or cash—or retreat into paralysis by avoiding their portfolios altogether.
- **Star Gazing.** Classic economic theory suggests that investor decisions are based on knowledge gathering and analysis. Behavioral research suggests that most investors do very little of either. They tend to rely on headlines, listen to their gut reactions, follow the crowd, and seek out rumors more than systematic analysis. For example, investors will often chase investment stars, those funds that have performed well recently. And the evidence indicates that highly active funds that have recently outperformed will soon revert beneath the mean, i.e., they tend to underperform their peers.
- **Expenses.** Investment expenses play an important role in investment returns. It is well known that higher expenses lead to lower returns. However, research has shown that individual investors rarely consider expenses (higher or lower) in their investment decisions. They tend to follow recent returns, even though relatively expensive funds are likely to underperform over the long run. Crises make it especially hard for investors to focus on the small, but important things that can make a real difference.

Although we have called these behaviors dysfunctional, they are very common. They are also extremely hard to change. But there are ways to resist temptation, and there is no time when it is more important to do so than in a crisis like the one we are now experiencing. What can the average investor do in a time like this?

CONTINUE TO TAKE THE LONG VIEW

Investing is a long-term activity. Even when markets crash, investors should remind themselves that owning assets in the equity, bond, real estate, and other markets over extended periods has historically been profitable, providing higher returns than bank deposits. So resist the natural urge to overreact and trade rapidly, which could lead you to lock in your losses or reduce your ability to take advantage of riskier assets, leaving you with assets that are less likely to rise when markets begin to recover.

Similarly, you should avoid paralysis by taking a hard look at your portfolio to see how the market has affected not just its size, but also your allocation between riskier and less risky assets. Even more, think about when you should rebalance back toward the asset allocation that you originally chose, taking small but systematic steps to buy back into assets that have lost value.

AVOID MARKET TIMING

At times like these, it seems as though the winners are those who got out of stocks at the right time and will get back into risky assets when times get better. Rest assured, you will hear stories about investors who got it right and whose portfolios increased in value despite the market downturn. But be skeptical about those stories if the claim is made that the successful investors had unique insight rather than luck or “swing betting.”

It is hard to know when the market is topping out and even harder to know when it is bottoming out. And you have to be right twice to time the market successfully. For example, if you had invested \$100 in the Dow Jones Industrial Average in 1900 and let it ride, you would have accumulated about \$25,000 by the end of 2007. If you had missed the 10 best days in the market during that period, you would have accumulated only about \$9,000. If you had missed the 100 best days, you would have ended up with less than you started with (\$78).

RESPOND TO THE VERITIES RATHER THAN THE RUMORS

Just because other people think it is a good investment idea to do something doesn't make it good for you. Your circumstances are special, and the keys to investment returns are still true. Savings, not just investment returns, will provide a sizable portion of your future nest egg. You shouldn't stop saving just because markets are going down.

Asset allocation is still the most critical factor in explaining the differences in returns among portfolios. So you should continue to think of diversifying your portfolio as the most important thing you can do after saving. As we mentioned previously, staying fully invested rather than hiding in cash will put you in a position to take full advantage of future market upturns.

GET TRUSTED ADVICE

Finally, and above all, seek out and work with a trusted advisor. By that we mean someone with the credentials and reputation to help you overcome some of the behavioral pitfalls in order to see the big investment picture. Such an advisor won't primarily tell you what to do. He or she will ask you questions designed to elicit your tolerance for risk, your individual and family circumstances, your long-term investment goals, your market outlook, and your level of knowledge. This can assist both you and your advisor in considering appropriate options for your savings and investments.

It is understandably hard to take the long view and seek advice when markets are moving as rapidly as they are. But now, more than ever, it is important to look beyond the immediate conditions so that you aren't caught up in considerations that turn out to be short-sighted. Taking some of the preceding comments to heart can help you begin that process.

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