KIM: Investors can’t grow wealth being scared

Mickey Kim
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With investor confidence plunging to depths last seen during the global financial crisis, this seems like is a good time to revisit one of Warren Buffett's foundations of investing: "Be fearful when others are greedy, and be greedy when others are fearful."

Economic growth has been subpar, corporate profits are challenged and the political outlook is chaotic.

In addition, investors still carry the financial wounds and psychological scars of 50% plus stock market collapses in both 2000-2002 and 2007-2009. Stocks have staged a strong recovery from their early-2016 collapse, but nobody wants to be Charlie Brown, believing ***this i***s the time Lucy ***doesn’t*** yank the football away just as he’s getting ready to kick it.

As a result, various readings of investor sentiment have reached multi-year lows and shareholders of stock mutual funds have yanked out more than $64 billion in 2016, the worst start for a given year on record. In addition, activity in initial public offerings (a sign of investor exuberance) is tepid. Through May, only 31 U.S. companies went public, down from 69 and 115 in the same period in 2015 and 2014.

Trust me, I get it. Still, history suggests the greatest opportunity is when ominous storm clouds are everywhere and the biggest risk is when there is nothing but blue sky on the horizon.

BofA Merrill Lynch Global Research measures Wall Street’s bullishness on stocks with its “Sell Side Indicator,” which tracks the recommended stock allocations of a group of market strategists. At the end of May, the Sell Side Indicator fell to 51.6, its lowest level in 15 months and below its level at the market lows of March 2009.

This is important because the Sell Side Indicator has been a reliable ***contrarian*** indicator. Historically, it’s been a bullish signal when Wall Street was extremely bearish and vice versa. When this indicator has been this low or lower, ***total returns over the subsequent 12 months have been positive 97% of the time, with median 12-month returns of 25%. Of course, past performance is no guarantee of future results.***

Dalbar recently released its 22nd annual Quantitative Analysis of Investor Behavior (QAIB) study, which continued to show how poorly investors perform relative to market benchmarks over time and the reasons for consistent underperformance (primarily investors’ tendency to buy high and sell low—i.e. the “behavior gap”). Their conclusion was “investment results are more dependent on investor behavior than on fund performance.” Further, “mutual fund investors who hold onto their investments have been more successful than those who try to time the market.”

Specifically, for the year ending December 31, 2015, investors in stock funds had a return of -2.28% while the S&P 500 eked out a return of 1.38%, a behavior gap of -3.66% (which was an “improvement” over 2014’s gap of -8.19%). While a negative behavior gap is costly over the short-term, it is devastating when compounded over many years. According to Dalbar, investors experienced 20-year average annualized returns of 4.67% vs. 8.19% for the S&P 500, a gap of -3.52%. That might not seem like a lot on a percentage basis, but assuming an initial $1000 investment, the average fund investor ended up with $2,491 vs. $4,827 in the S&P 500, a ***20-year behavior gap of $2,336 or 94%.***
