Break free from anchors, short-term focus to boost returns

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INVESTING
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Assume I told you at the beginning of the year the S&P 500 Index had an average annual return of 8.8% for the 38-year period between 1980 and 2017. I then asked you to provide a range of returns you expected the S&P 500 to provide over the next twelve months, between ____% and ____%.

If you're like most folks, you'd focus on the 8.8% average annual return and make a mentally wide cushion of plus or minus 4.4% (half the average), to come up with a range of 4.4% to 13.2%.

That may seem perfectly reasonable, but by focusing or anchoring on the 8.8% average annual return, you probably wouldn't realize ***actual calendar year returns over the 38 years were almost never even close to the average.*** In fact, ***calendar year returns were between 4.4% and 13.2% in only seven of the 38 years (i.e. less than 20% of the time).***

According to J.P. Morgan, calendar year returns ranged from ***+34% to -38%***. Further, ***despite an average intra-year peak-to-trough drop of 13.8%, returns were positive in 29 of 38 years.*** While nine of 38 years (i.e. almost 25%) were negative, I'm guessing very few of you had a negative (and certainly not -38%) as the bottom end of your expected range.

Behavioral economists believe we often act emotionally and irrationally and are impacted by all sorts of cognitive biases. They refer to the cognitive bias of focusing on a starting or reference point, like historical average returns, as ***anchoring***.

Investors crave certainty and having a tight range of expected outcomes around the anchor creates an ***illusion*** of certainty. The problem with anchoring is it fails to recognize the ***extreme volatility inherent in stocks***. So, when the market encounters a bout of perfectly normal volatility, like we've experienced over the past several weeks, investors can become unnerved and abandon their long-term strategy.

So what's an investor to do? First, recognize and accept the range of possible outcomes is ***much*** wider than you realized (including large negative returns) and short-term returns (like next 12 months) are completely unpredictable. Second, rejoice that ***the longer your investment time horizon stretches, the less important this short-term volatility becomes.***

Crandall, Pierce & Company gathered monthly returns for the S&P 500 from January 1950-September 2018 (813 observations) and calculated "rolling" annualized returns for 1-, 3-, 5-and 10-year periods. For instance, the first rolling 1-year return was calculated from January 1, 1950-December 31, 1950, the second from February 1, 1950-January 31, 1951 and so on.

As shown in the table below, as your time horizon ***lengthens***, 1) the ***range*** between the best and worst returns shrinks, 2) the ***worst return*** is smaller and 3) the ***percentage*** of positive returns increases.

	Average Return	**Best Return**	**Worst Return**	**Percent Positive**
1-Year	12.50%	61.20%	-43.30%	79%
3-Year	11.30%	33.30%	-16.10%	89%
5-Year	11.10%	29.60%	-6.60%	92%
10-Year	10.40%	19.50%	-3.40%	97%

Because of the power of compounding, ***time in the market is much more important than timing the market, which is both futile and harmful.*** Crandall, Pierce calculated that if you invested $100 in the S&P 500 at the beginning of 1968 and left it untouched until the end of 2017 (50 years), it would have grown to $2,771.44. On the other hand, if you had tried to dodge the countless calamities that are always out there and missed just the ***single best market day*** in each of the 50 years, you would have ended up with only $500.73, or ***82% less than if you had stuck it in a drawer and forgotten about it***.

Similarly, J.P. Morgan found that during the 20-years from January 1, 1998 to December 31, 2017, ***six of the Best 10 Days for the market occurred within two weeks of one of the Worst 10 Days, making it highly unlikely you would have been smart/nimble/brave enough to jump out and back in***. Missing a single best day is devastating to long-term returns. The ***only*** way to avoid this is to ***be invested when those best days occur***, which can ***only*** happen if you endure the short-term pain.
