Game-Changer Investing

By Roger Balser
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Stick With the Plan, Stan

Augusta National Golf Club in Augusta, Georgia, will once again play host for the 2016 Masters Tournament, slated for April 7th. If you're a golf fanatic like I am, I'm sure you're anxiously anticipating the showdown between the sport's newest generation of superstars like Jordan Spieth, Jason Day and Rory McIlroy.

The Masters Tournament challenges its vaunted participants by forcing them to develop a disciplined playing strategy that is centered on their individual strengths and weaknesses. A winning game plan that the golfer can trust even after the dubious double-bogey on the famous 13th hole. Can you imagine any of these pro golfers not planning a strategy for this tournament?

And just like golf, investing also requires a disciplined game plan.

I find it very interesting that, when the markets are calm and I speak with a prospective client for the first time, I always talk in broad general terms about strategies. But it seems to me that when the markets are going haywire that folks really don't want to discuss strategy. They prefer panic and chaos, and tend to rip up their game plan to plod along with the uniformed and dump everything. They abandon their game plan.

As an investor, wholly trusting your investment strategy isn't easy. It doesn't matter what strategy you subscribe too, be it buy-and-hold, value investing or my personal favorite, relative strength. All strategies will at some point in time hit a rough patch and subsequently underperform. And it's nearly impossible to stick with a strategy during a period of underperformance or volatility.

You should know that ditching your game plan when times get tough is a recipe for disaster. You may as well not even have a strategy at all. Unfortunately, that's what people do when the market starts pulling back.

The 2015 DALBAR Quantitative Analysis of Investor Behavior report supports this premise. The report states that for the last 20 years the average investor has earned annualized returns just north of 5 percent (5.19 percent to be exact). Over the same time period the Standard and Poor's 500 Index (S&P 500) returned 9.85 percent.

So the S&P 500 has earned an annualized return of almost 10 percent while the average investor took home about half that amount.

Why the *Big* Gap Between Investors and the Index?

The main reason the S&P 500 is able to outperform the average investor is that index doesn't have any emotions. It's just an index. It doesn't read the newspaper or watch the pundits on television. The whole idea with the S&P 500 is it buys the 500 largest publicly traded companies in the U.S. and weights them according to their market capitalization.

It's a very simple strategy. It makes changes when it's appropriate to make changes. It doesn't say, "Oh, the market is in trouble. Time to ditch." That's not how the S&P's strategy works. It doesn't deviate from its strategy based on market conditions. These are its rules and it must abide by them. We should all take a page out of its book and become just as loyal to our own investment strategies.

Through more than 25 years in the investment business, I've seen study after study that supports the fact that rules-based, statistically driven models typically outperform humans. But when underperformance or market volatility rears its ugly head, our brains tell us to ditch. The strategy is broken.

Why Is It That Investors Don't Trust a Rules-Based Strategy?

This phenomenon has been dubbed "algorithm aversion" in an excellent research paper entitled, "Algorithm Aversion: People Erroneously Avoid Algorithms After Seeing Them Err" published by the American

Psychological Association.

The paper states that, despite proven research which demonstrates the superiority of evidence-based algorithms to human forecasters, people continue to show more willingness to trust an emotional human being over a set of emotionless rules. Here's an excellent example of this behavior from the paper:

"Imagine that you are driving to work via your normal route. You run into traffic and you predict that a different route will be faster. You get to work 20 minutes later than usual, and you learn from a co-worker that your decision to abandon your route was costly; the traffic was not as bad as it seemed. Many of us have made mistakes like this one, and most would shrug it off. Very few people would decide to never again trust their own judgment in such situations. Now imagine the same scenario, but instead of you having wrongly decided to abandon your route, your traffic-sensitive GPS made the error. Upon learning that the GPS made a mistake, many of us would lose confidence in the machine, becoming reluctant to use it again in a similar situation. It seems that the errors that we tolerate in humans become less tolerable when machines make them."

Simply put, we're less apt to trust a system of rules than our own instincts or those of another human. This is problematic because, as I pointed out earlier, emotionless, rules-based investment strategies have been proven to outperform most human investors. Even the S&P 500's simplistic strategy of owning large cap U.S. stocks outperforms, mostly because it just plays by the rules.

Trusting a rules-based strategy isn't always going to be easy, but in the long run you'll likely be very happy you stuck with it.

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