In this issue

When Every Instinct Is Wrong

Panic selling is almost always a bad idea, but staying invested through turbulent times is easier said than done. Let's look to one of the greatest comedic characters of all time for advice on how to handle market volatility.

Recent volatility has been a harsh reminder that stocks tend to go up in escalators and down in elevators. Selloffs are emotionally taxing because they tend to amplify loss aversion and other powerful emotional responses. As declines worsen, many investors simply throw in the towel because they can no longer take the pain.

The chart below explains why panic selling is almost always a bad idea. Purple bars indicate the annual price return on the S&P 500 since 1980. Red dots highlight the largest drawdown (peak-to-trough decline) each year.

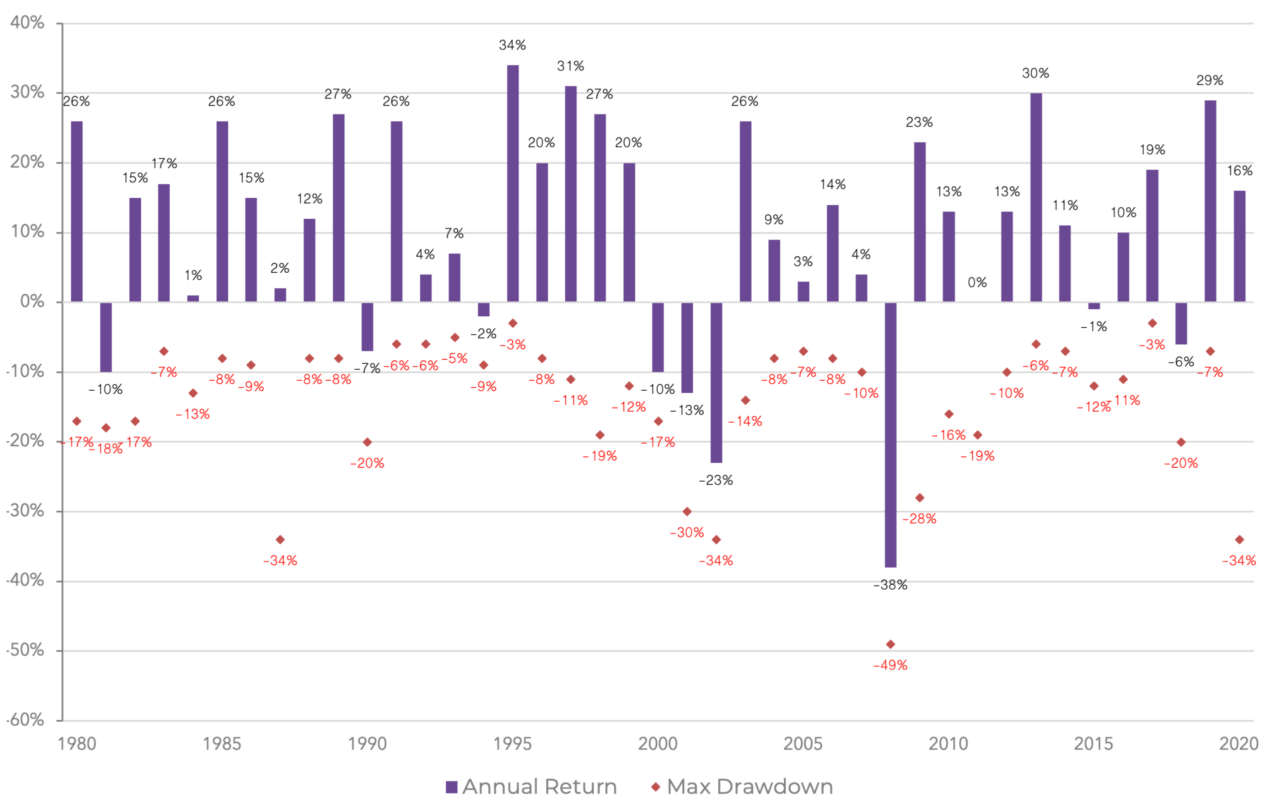
For example, in 2019, the S&P 500 ended the year up 29% (not including dividends), despite dropping 7% at one point during the year. In 2009, the index finished up 23% but also fell 28% at one point.

Three observations are worth noting:

1. **Drawdowns happen annually**: Over the past four decades, every year had some period of decline.
2. **The average is quite high**: Since 1980, the average intra-year decline is 14.3%.
3. **Big drawdowns are common**: Double digit declines occurred 56% of the time. Drawdowns of 15% or more happened one out of every three years.

While these observations may be unsettling, consider the following:

S&P 500 Intra-Year Declines vs. Calendar Year Returns



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2020.

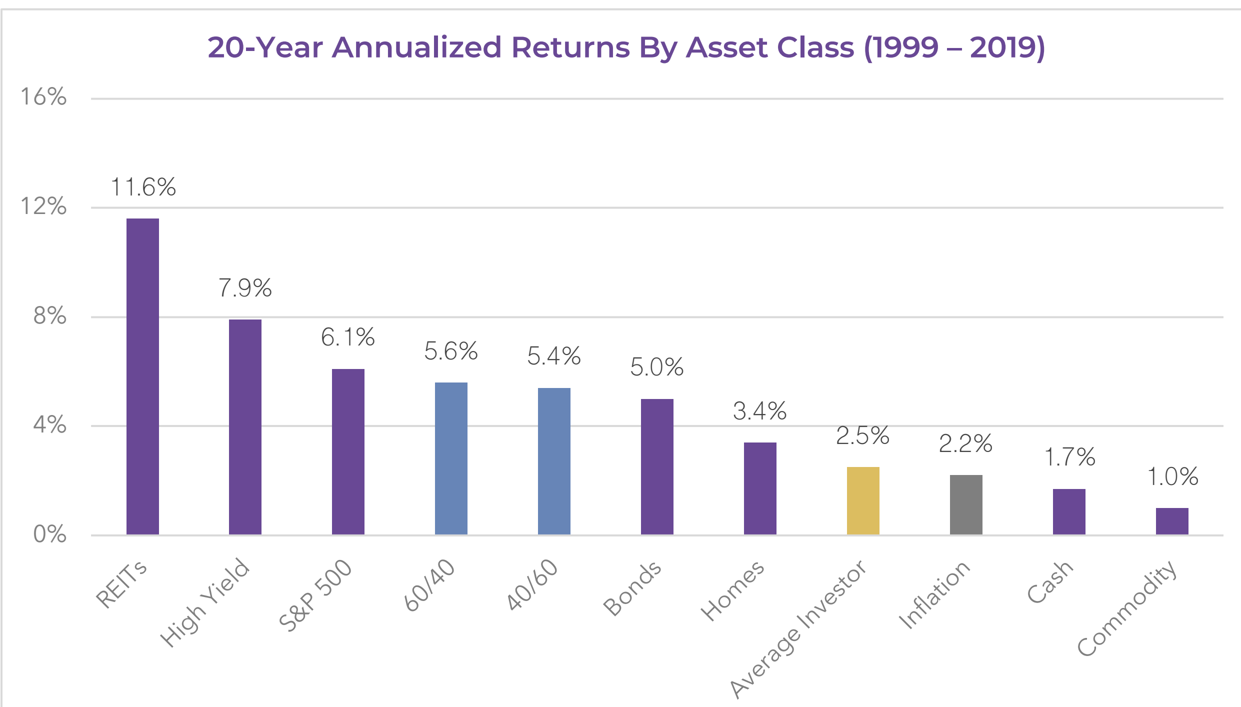
- Despite an average intra-year decline of 14.3%, annual total returns were positive 34 of the 41 years[1].
- Years that endured a 10% or greater drawdown still delivered a positive total return 75% of the time.
- Just over half of the years that had a drawdown of 15% or more also delivered a positive total return.

Meaning, most drawdowns were short-lived and had little to no lasting impact on the long-term direction of the index. Investors who kept cool and ignored the urge to sell into panic were rewarded.

Unfortunately, the chart below suggests that the average investor is probably not doing that. It compares the annualized returns over a 20-year period for various investments. The average investor (yellow bar) not only earned a fraction of a balanced portfolio (blue bars), they also barely beat inflation (grey bar). The relatively poor performance is likely due to behavior rather than the holdings in a portfolio. More specifically, the average investor tends to chase performance and sell into panic, and the combination of these has created subpar returns over time.

The Bottom Line

Trying to pick your favorite *Seinfeld* episode feels a lot like force-ranking your kids, but one of the all-time best was when George Costanza came to the realization that every instinct he has is wrong. Down and depressed, Jerry suggests that he should do the opposite of what his gut tells him to do. His argument was if every instinct George has is wrong, then the opposite would have to be right. George agrees, and



Source: J.P. Morgan Asset Management – Guide to the Markets, 1Q 2021, As of December 31, 2020 upon following this advice, his life immediately turns for the better.

Most of the genius that made Seinfeld so memorable is nothing more than a comedic portrayal of real life, and this episode is no different. In fact, Costanza could even be viewed as a mentor to investors that fear volatility. We are programmed with instinctive behaviors to keep us safe from harm. Walk down a dark alley, and we become more aware to sound. When financial markets become more volatile, our instinctive response is to try to protect our wallets from perceived danger.

But our instincts aren't always right, particularly during turbulent markets. More often than not, doing the opposite of what our gut tells us to do is the best course of action. I'd even argue this is what truly separates successful investors from average ones. Sure, analysis and fancy degrees can help, but they can't predict human behavior or temper a painful drawdown in stocks.

The challenge here is that going against your gut is hard. No matter how many times you do it, that voice in your head will try to convince you that this time is different. Therefore, if you ever find yourself thinking this way, revisit the two charts above and then [watch this clip] repeatedly until the urge to act is quelled[2].

The bottom line is that being a successful investor is so hard because success is often defined by when we ignore instinct versus follow it. So, the next time stocks go down in an elevator, summon your inner Costanza. Remind yourself that drawdowns are rarely a problem unless your instincts let them become one.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

1 Bloomberg

2 https://www.youtube.com/watch?v=1Y_6fZGSOQI

Disclosures