McCARTHY GRITTINGER
FINANCIAL GROUP LLC

Predictions and Investor Psychology

Dear Valued Clients & Friends:

"We really can't forecast all that well, and yet we pretend that we can, but really can't."
-Alan Greenspan

"In order to be successful, an investor has to understand not just finance, accounting, and economics, but also psychology"
- Howard Marks, Co-Chairman Oaktree Capital

Predictions and Investor Psychology

As we put together our 2016 outlook newsletter, a few themes continue to rise to the top and the question of which topic to write about became an easy answer: investor psychology and market predictions. When viewed together, you can see how easy it is for an investor to get caught up in both.

If you read the newspaper, listen to the radio, watch the nightly news, or scroll the internet, you have seen "expert" predictions:

This happened yesterday because of X
This happened yesterday because of Y
This is going to happen tomorrow because of Z

What is fascinating about reading and listening to these forecasts is the lack of follow-up to grade the level of success. People will freely give their predictions. However, those same people are hesitant to review and to grade those predictions. *For an excellent book discussing this expert foresight topic we would recommend, Superforecasting: The Art and Science of Prediction, by Philip Tetlock and David Gardner.*

Listening to these market prognosticators really provides a disservice to individual investors. These market predictions prey on investor psychology. They use the benefit of hindsight to make investors feel they are missing something. It would be easy to find an article or news clip of a commentator claiming investors should have reduced their equity exposure before a 10% drop in price. However, it would be difficult to find information on when that commentator reduced their equity allocation and when they subsequently increased their equity allocation (or how many times they have tried this and been wrong in the past!). As we remind clients, market timers have to be right twice. They have to be right on the way out and on the way back in. Not only that, but they have to be right to the level that outweighs the increased costs and taxes of making the various trades. This may seem easy in hindsight, but research shows that it is very difficult in practice.

We have to continue to remind ourselves the value of the investment process. Our investment plans are created in order to have the best probabilistic chance of **long-term** success. What we know from probability theory is that good investment strategies sometimes lead to poor short-period results. There is no strategy that works well in every situation during every time period. The power of acknowledging this is extremely strong. The best investors know this and are honest about it in their communications. They use this knowledge to move through volatile time periods like those we have just experienced these first few weeks of 2016.

Financial Markets

With that in mind, here is a look back at the 2015 fourth quarter. The fourth quarter returns were mainly positive and recovered some of the drop experienced in the third quarter.

Index - Through 12/31/15	**4Q**	**1 YR**	**3 YR**	**5 YR**
S&P 500 (large-caps)	7.04%	1.38	15.13	12.57
Russell 2000 (small-caps)	3.59	-4.41	11.65	9.19
MSCI EAFE NR USD (foreign)	4.71	-0.81	5.01	3.60
MSCI All Country World Index (foreign and US)	5.03	-2.36	7.69	6.09
Barclays US Aggregate Bond Index	-0.57	0.55	1.44	3.25
Source: Morningstar. All calculations represent total return and are annualized for periods exceeding 1 year.				

Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Index returns are not representative of actual portfolios and do not reflect costs and fees associated with an actual investment. Actual returns may be lower. Source: The S&P data is provided by Standard & Poor's Index Services Group.

Takeaways

Investors earn their market equity premium when stock market volatility spikes and they are able to stick with their long-term plan. Throughout history, there is a long list of investors causing themselves financial harm by not sticking to their investment plan. As we have seen, there is always a story or expert-of-the-day that could cause an investor to react inappropriately. Thus, in order to combat this we must all be reminded of our own long-term plans and that these long-term plans do not always "win" in the short-term. Having the ability to recognize and to trust that wisdom will provide the foundation for future success.

As your Anxiety Removal Team® we stand ready to discuss and review any changes in your personal situation. We are here to help navigate this volatile start to the year and would welcome a discussion to answer any questions or concerns you might have. Just give us a call.

If someone you know is having difficulty handling these volatile markets and interpreting what it means to their personal situation, please feel free to pass along our contact information or forward this eNewsletter.

Wishing You All the Best in 2016!

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