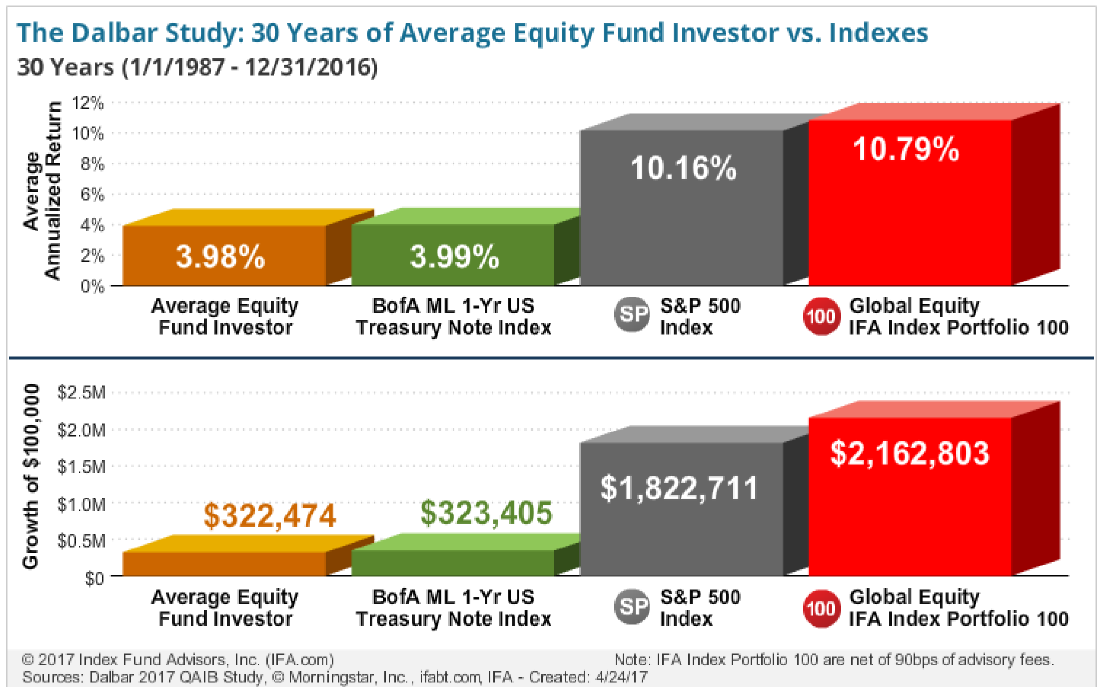
Lynx
Investment Advisory

Keys to Financial Success: How Behavioral Tendencies Can Impact Accumulation and Transition Planning

As we write this paper, the markets appear to have calmed after the extreme shift toward high volatility during the month of February 2018. Concerns about inflation and rising interest rates caused an abrupt shift from the low volatility environment we had been experiencing for the past several years. Prior to the shift, investors seemed to be on either side of the equation in terms of risk appetite, either expecting a continuation of the eight-year bull market, or worried that a correction was imminent and holding too much cash. The former group continued to pile into equities while the latter avoided them out of fear of a sell-off. We argue that neither approach was correct because it was not necessarily driven by a disciplined adherence to goals-based investing principles, but rather, by emotion.

In order to enjoy financial success, one should be keenly aware of our propensity as humans to allow emotions to dictate decision making. According to Dalbar, a financial services market research firm, investment results are driven more by investor behavior than by actual fund performance. The following chart is a sobering reminder of how market timing and emotions can wreak havoc on investors' returns, and financial futures.



Based on these results, the average equity investor would have been as well off by simply rolling over 1 year Treasuries over a 30-year period, without the associated risk of the stock market. Furthermore, a passive buy and hold approach in the S&P 500 would have yielded an additional $1.5 million in savings over a 30 year period! Fidelity Investments ran their own study based on the returns of the Magellan fund under the leadership of legendary manager Peter Lynch. Fidelity noted that while the average annual returns of the fund itself were an astounding 29% from 1977-1990, the average investor in the fund actually lost money during that time by making emotional decisions—adding more after strong performance, selling during downturns, and outright market timing. You read it right, the average investor lost money in arguably the most successful mutual fund in history!

Investment professionals are often asked, "what is your value-added as an advisor?" Is it manager selection, asset allocation guidance, comprehensive wealth management? Perhaps the answer is very straightforward, that the advisor should serve as an objective and trusted resource and advocate, steering clients away from emotional decision-making, and avoiding mistakes that may have significant and long-lasting, if not permanent implications.

While we have discussed the behavioral aspects of investing during the wealth accumulation phase, emotions and psychology play an equally important role in wealth and estate planning, the transition phase of leaving money to heirs and charities. Avoiding mistakes is critical in this part of the planning cycle as well.

Perhaps the biggest mistake is not having a plan at all, or a poorly communicated one. According to one study, 70% of wealth never transfers to a third generation, and the main reason is lack of communication.[1] Perhaps parents are reluctant to discuss finances with their children for fear of changing the family dynamic, or perhaps there is ambivalence regarding how the money should be distributed among beneficiaries and/or charities.

Other transition planning errors include not having an updated will and not updating beneficiary information on retirement and other accounts. Incomplete or incorrect beneficiary information can create significant and long-lasting implications for those family members left behind, and it is arguably the easiest mistake to avoid.

Finally, in situations where one spouse is more financially engaged or interested than the other, it is important to involve the other in meetings and conversations. It is essential that they be aware and knowledgeable of the family financial picture so that they are prepared and informed should the need arise.

In conclusion, while as human beings we may never completely eliminate emotion from our decision-making, maintaining a healthy self-awareness of our tendencies should help guide us through some of the challenges that may arise. If a decision feels too comfortable, perhaps it's the wrong one.

Date: March 2018

[1] Source, MFS Investment Management