Global Financial
Private Capital

Protecting Against Pilot Error

SYNOPSIS

- A survey conducted back in 2015 indicated that 37% fear the stock market and 73% equate buying equities to gambling.
- Given the events that have transpired in equity markets since the late 1990s, it is understandable to hear that investors feel that the stock market is rigged.
- Hiring a professional and proper diversification are two ways to avoid costly mistakes.

FEAR AND DISTRUST

I flew back to New York City last week and encountered turbulence on the descent towards LaGuardia Airport. As the plane made its way to the gate, I noticed that the woman next to me was in tears and shaking uncontrollably. After she calmed down a bit, we began talking and came to learn that she was just a nervous flyer.

The experience reminded me of a survey I read back in 2015, which questioned over 1,200 Americans what scares them the most. At the top of the list were the usual suspects, with 46% fearing death and 49% being afraid of heights[1].

Equities were not far behind, with 37% of respondents fearing the stock market. Furthermore, around 73% consider investing in the stock market to be a form of gambling, and 31% believe that the stock market is rigged[1].

The reasons for investor fears are not overly surprising, as respondents cited the perceived high risks involved. Common responses included, "I'm afraid of losing money," and, "I don't have time to watch the market." Others stated that they don't trust someone else making investment decisions for them.

Let's address these concerns one-by-one. First, in no way whatsoever is the stock market rigged. The U.S. equity market is much too large to be manipulated to the point where only a select few profit on a consistent basis.

Second, the stock market is absolutely used as a casino by day traders. Attempting to profit from short-term price movements is no different than rolling dice down a craps table. In fact, it is arguably even more difficult to day trade because it requires a gambler to be right twice – when to buy and then when to sell – on each trade.

All that can be done is to best position this cohort to protect themselves against pilot error.

However, those investors who focus on the fundamentals of companies and ignore the day-to-day market movements are not gambling. They are developing an investment thesis and observing its progress over a multi-year period. The difference may appear to be subtle, but rest assured the two strategies couldn't be more different.

Regarding the "fear" component of the market, the chart below shows the return on the S&P 500 compared to gold, which is often cited as a "safe haven" asset, from 1980 through March 31, 2017.

Even through the madness of the dot-com bubble and the financial crisis, stocks have generated over 2,090%, which is 14 times larger than gold's 143% return. Furthermore, gold has never paid a dividend, bought back shares, or engaged in any other shareholder-friendly activity. It has just sat there like a shiny pet rock, while the S&P 500 has created tremendous wealth for patient investors.

Gold's paltry return sheds light into the irony of most "safe" assets. Although they may make an investor sleep well at night, their inability to generate attractive returns over time could pose far greater risk to meeting financial objectives than the stock market ever could.

Hence, some may claim that fear of stock ownership is irrational, but I find it to be no different than the nervous flyer sitting next to me. Consider the following:

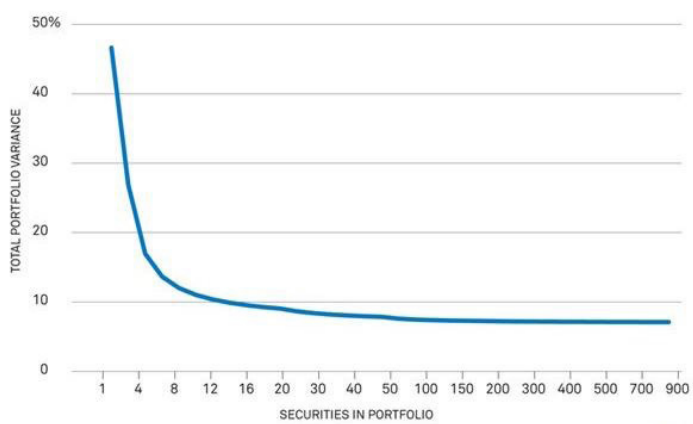
- **Bad Events Resonate:** Even though plane crashes are extremely rare, people often perceive air travel as dangerous. The same goes for equities in the sense that fraud and financial crises rarely occur, but when they do they can resonate for decades.
- **Giving Up Control is Scary:** If you have no experience as a pilot, would you ever get in a cockpit? The same applies to the stock market, so don't try to do it yourself unless you have the proper training and logged years of experience.
- **Real Risks Aren't Obvious:** Although turbulence (aka "volatility") is how most passengers gauge the safety of a flight, pilot error is almost always the cause for crashes. The same goes for managing equity portfolios. Either making aggressive moves and/or panicking in challenging times is a sure path to suboptimal outcomes.

This passenger even admitted to knowing the statistics around flying. She understood the odds of bad things happening were infinitesimally small, but the data provided no comfort. This came as no surprise because during moments of extreme emotional stress, applying logic and reasoning is akin to bringing a knife to a gun fight.

Regarding the survey, I doubt that there is a single respondent who would listen to reason when it feels like their entire net worth is heading to zero. Hence, whether it is rational or not for some to fear the stock market is irrelevant. All that can be done is to best position this cohort to protect themselves against pilot error.

IMPLICATIONS FOR INVESTORS

The chart below shows the relationship between the number of securities in a portfolio (horizontal axis) and the overall risk of the portfolio (vertical axis – "variance" is a fancy word for a measure of risk).



Source: Modern Portfolio Theory and Investment Analysis, Ninth Edition

This chart explains why diversification is so critical. As the number of securities increases, the risk decreases dramatically. If an investor owns 5 stocks and one is in a company that commits fraud, then 20% of the portfolio is exposed to this risk. By owning 50 stocks, only 2% of the portfolio is at risk.

Furthermore, while a single stock can go to zero due to several reasons, properly diversified portfolios cannot. Maintain diversification through economic booms and busts, and an investor should not have to stay up at night wondering when the next Enron or Bernie Madoff will happen.

There's no question that another crisis will occur down the road. These events will catch headlines and boost financial news network ratings just as they have in the past, but timing them is impossible and any attempt to try will only cause more harm than good.

Rather than play a guessing game, I prefer to invest in diversified portfolios that contain built-in protection. This approach takes the timing and risk of pilot error out of the equation.

The bottom line is that a professionally managed, well-diversified portfolio is the best way to help investors cope with their fear of the stock market.

Sincerely,

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[1] http://www.creditdonkey.com/afraid-investing.html