



Peccadilloes: Recency Bias

Spring 2007

The Tendency to Extrapolate Events from the Recent Past into the Future

Past performance does not predict future results.
—SEC Disclosure

The SEC requires this disclosure from brokers and investment managers on nearly every document and as a part

of every engagement. Yet, it doesn't stop investors from focusing almost entirely on the recent past in making their decisions.

When I ask investors how they choose their mutual funds, almost invariably the answer is: I buy what's going up. Of course, what they're really saying is I buy what's *gone* up. And, we don't just exhibit this behavior in our investment lives. I bought window bars for my house in Denver right after being burglarized—too late!

Recency bias is among the cognitive behaviors that cause us to make decisions based upon greed or fear, rather than from a dispassionate and well-thought-out, long-term strategy. Data from Morningstar shows that, by and large, investors chase the performance of hot funds and managers.

Typically, the timing of investment decisions based on this behavior is awful. Such "herd mentality" bids up the price of popular investments to the point they become overpriced. This behavior is partially what caused the technology bubble of the late 1990s and its bursting in 2000–2002. Is this now happening in real estate or commodities or emerging markets?

Regression to the mean in returns is one of the most powerful forces in investing. Investments that have had above average returns in the recent past, once the music stops, are actually likely to have below average returns going forward. Benjamin Graham summed it up best: "In the short-term, the markets are like *voting machines*, but over the long-term they are like *weighing machines*." Long-term returns are based upon the fundamentals of the economy and of individual companies.

The antidote, of course, is systematic and disciplined rebalancing of portfolios—averaging out to a buy low/sell high strategy. When investments in one asset class have been driven up—out of balance—by the market, rebalancing causes them to be sold and with proceeds getting reinvested in underperforming asset classes. It's good way to avoid a bursting bubble.

Summary: Our Peccadilloes!

RightPath introduces an occasional guide to help you reduce those seemingly small mistakes in managing your portfolio that add up over time. Our "Peccadilloes" columns are based upon behavioral finance, for which Princeton Professor Daniel Kahneman won the Nobel Prize in Economics in 2002.

Behavioral finance identifies a laundry list of cognitive and emotional biases—or behavioral mistakes—we all tend to make in our financial decision-making. Think of them as mental traps that, once recognized, we work to avoid in managing our portfolios.

We hope you enjoy this inaugural topic and look forward to bringing you a fresh look at practical ideas to improve your financial well-being.

This time: Recency Bias.