The Intelligent Investor: The Worst Advice? 'Just Trust Your Gut'

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ABSTRACT

[...]investors tend to be complacent when they should be worried and afraid when they should be optimistic.

FULL TEXT

With U.S. stocks surging this past week and breaking into the black for 2016, remember: What you expect the stock market to do next is shaped largely by what it just did.

Earlier this year, when stocks lost 5% in January and were down 10.5% at their worst, individual investors were the most pessimistic they had been since March 2013, according to surveys conducted by the Yale School of Management.

And if history is any guide, the mood of investors already is lifting in lock step with stock prices. The more stocks go up and the faster they rise, the more likely you become to expect more of the same. And when they go down, your expectations fall with them. Investors are often told not to get caught up in other people's emotions -- but it at least is as important not to get swept away by your own.

New research hammers that point home. Finance professors William Goetzmann and Robert Shiller of Yale, along with Dasol Kim of Case Western Reserve University, have analyzed the Yale surveys and found that investors' forecasts regularly look more like aftercasts -- simple projections of the recent past into the future.

Prof. Shiller, who won a Nobel Prize in economics in 2013, has been surveying investors about their expectations since 1989.

You can ask yourself one of the key questions: What are the odds of a one-day crash of at least 12% in the U.S. stock market over the next six months?

You probably answered at least 10% -- even though that is roughly 10 times the likely chance of a disastrous daily crash in the coming six months, based on the historical record. (The 87 years from 1929 through 2015 consisted of 174 six-month periods. But, with only two single-day crashes of at least 12% over that span, such declines occurred in just over 1% of the half-year periods.)

Remarkably, professional investors exaggerate the odds almost as badly as individual investors do. Over time, both groups overall have tended to put the odds of a crash at around 20%, with the institutional investors' estimates ranging only about one to three percentage points below that.

What's more, the new study suggests, you probably would have put higher odds on an imminent crash back in

January than you would now or would have six months or a year ago. That is partly because a sharp recent drop makes future declines seem more probable, and partly because the news media uses words like "crash" much more often after the market falls sharply.

Words charged with negative emotion not only darken your view of the future, but they may make you feel that riskier investments have a lower -- rather than a higher -- potential return.

Dates like Oct. 28, 1929, and Oct. 19, 1987, when the Dow Jones Industrial Average fell 13% and 23% respectively, can "evoke a sense of doom," says Prof. Goetzmann of Yale. "Crashes have a remarkably long life in the public imagination. Their echoes can last for decades."

The Yale surveys also track the percentage of people who think the probability of a stock-market crash over the ensuing six months is less than 10%.

Naturally, investors tend to be complacent when they should be worried and afraid when they should be optimistic. From 2006 through mid-2008, as many as 58% of financial professionals thought the chances of an imminent crash were nil. Right on cue, the worst bear market in a generation began shortly thereafter.

Institutional investors then turned maximally pessimistic in February 2009, shortly before a new bull market took off. Responding to the survey on March 4, 2009, one wrote, "The way things are going, we will be at the bottom for six to twelve months." Three trading days later, the bear market ended.

Individuals are no better, of course. As an enthusiastic investor in Nasdaq technology stocks wrote in one of the Yale surveys, "The market today is not comparable to Oct. 19, 1987. WHOLE DIFFERENT WORLD." That was on March 10, 2000, the very day the Nasdaq bubble peaked.

No wonder the great analyst Benjamin Graham wrote in his book "The Intelligent Investor," after which this column is named: "The investor's chief problem -- and even his worst enemy -- is likely to be himself."

To be a true contrarian investor, remember that you have to act contrary to what others are doing -- but also to what you feel like doing yourself.

Credit: By Jason Zweig

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