PERSONAL FINANCE

What ‘Shark Week’ can teach investors about a money ‘survival instinct’

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KEY POINTS

- “Shark Week” is an annual block of TV programming on Discovery. It runs July 23 to July 29 this year.
- Perhaps the most famous shark — the fictional great white from the 1975 Steven Spielberg summer blockbuster “Jaws” — can teach investors an important lesson about behavioral bias.
- “Recency bias” is the tendency to put too much emphasis on recent events like a stock market rout when making investment decisions.

the ocean's apex predators. And perhaps the most famous of these fish — the fictional, man-eating great white from the 1975 thriller "Jaws" — can teach an important money-saving behavioral lesson to investors.

Specifically, investors have a tendency to get swept away by the fear or euphoria of the recent past. This is called "recency bias," and it's often accompanied by financial loss.

This bias leads investors to put too much emphasis on recent events — say, a stock-market rout, or the meteoric rise of bitcoin or a meme stock like GameStop.

"People need to understand that recency bias is normal, and it's hard-wired," said Charlie Fitzgerald III, an Orlando, Florida-based certified financial planner. "It's a survival instinct."

By Wildestanimal | Moment | Getty Images

Even so, allowing short-term emotion to guide long-term financial decisions is generally counter to investors' best interests, as is often the case when selling stocks in a panic.

Recency bias is akin to a common yet illogical human impulse, such as watching Steven Spielberg's classic summer blockbuster "Jaws" and then being afraid of the water.

"Would you want to go for a long ocean swim after watching 'Jaws'? Probably not, even though the actual risk of being attacked by a shark is infinitesimally small," Fitzgerald equates the impulse to a bee sting.

"If I get stung by a bee once or twice, I'm not going to go there again," said Fitzgerald, a principal and founding member of Moisand Fitzgerald Tamayo. "The recent experience can override all logic."

Recency bias is largely associated with FOMO

Here's a recent real-world illustration.

The financial services sector was among the top performers of the S&P 500 Index in 2019, when it yielded a 32% annual return. Investors who chased that performance and subsequently bought a bunch of financial services stocks "may have been disappointed" when the sector's returns fell 2% in 2020, a year when the S&P 500 had a positive 18% return, Aguilar said.

Fans celebrate the June 14, 2005, release of the "Jaws" 30th Anniversary Edition DVD from Universal Studios Home Entertainment.
Christopher Polk | Filmmagic | Getty Images

Among other examples posed by financial experts: tilting a portfolio more heavily toward U.S. stocks after a string of underwhelming performance in international stocks, and overreliance on a mutual fund's recent performance history to guide a buying decision.

"Short-term market moves caused by recency bias can sap long-term results, making it more difficult for clients to reach their financial goals," Aguilar said.

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Acting on that impulse is akin to timing the investment markets, which is never a good idea. It often leads to buying high and selling low, he said.

Investors are most vulnerable to recency bias, he said, when on the precipice of a major life change such as retirement, when market gyrations may seem especially scary.

What's in a well-diversified portfolio

Long-term investors with a well-diversified portfolio can feel confident about riding out a storm instead of panic selling, however.

Such a portfolio generally has broad exposure to the equity markets, via large-, mid- and small-cap stocks, as well as foreign stocks and maybe real estate, Fitzgerald said. It also holds short- and intermediate-term bonds, and maybe a sliver of cash, he added.

Investors can get this broad market exposure by buying various low-cost index mutual funds or exchange-traded funds that track these segments. Or, investors can buy an all-in-one fund, such as a target-date fund or balanced fund.

One's asset allocation — the share of stock and bond holdings — is generally guided by principles such as investment horizon, tolerance for risk and ability to take risk, Fitzgerald said. For example, a young investor with three decades to retirement would likely hold at least 80% to 90% in stocks.

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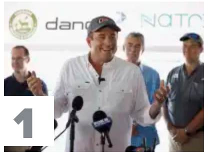

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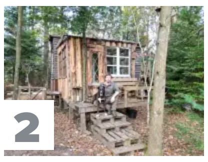

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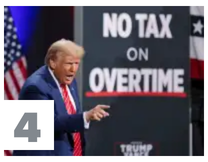

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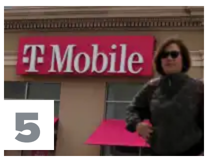

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