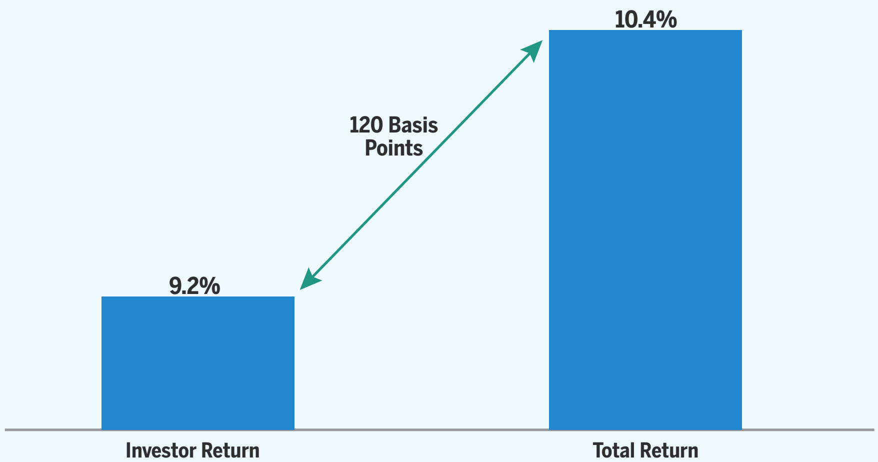
Avoiding Poor Decisions

Acting on short-term investment performance can lead to poorly timed decisions driven by emotion. How might investors improve their decision making and avoid the pitfalls of market timing?

The Average Investor Has Underperformed

Annual Returns for 10 Years Ending 2023 for Active U.S. Equity Mutual Funds and ETFs



Source: Morningstar Mind The Gap 2024. The annual total return calculation is time-weighted, where a lump-sum investment made at the beginning of the period and held throughout the entire measurement term. The investor return calculation is the internal rate-of-return that accounts for timing of all cash flows. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**

- Based on data from Morningstar, investors have underperformed active U.S. equity funds by more than 120 basis points annually over the past decade, primarily due to poor timing decisions. Morningstar further notes, "The average investor return lagged the average total return in all 10 of the calendar year returns that made up the decade we examined, underscoring the persistence of timing costs." Additionally, they found that investors incurred significant timing costs during periods of heightened volatility, such as in 2020 during the Covid-19 pandemic.
- Market drawdowns often provoke strong emotions, prompting investors to deviate from their long-term asset allocation goals. How might investors overcome instinctive pitfalls and navigate the market better? One answer is to use the "outside view." In behavioral finance, the "inside view" is derived when an individual forms a view based on specific details of a current situation, often relying heavily on personal experience and immediate information. The "outside view" is when an individual relies on data from comparable situations and utilizes evidence from others' experiences to form a view (see Looking Outside for Better Decisions).
- For example, while the inside view may narrowly focus on how a recent surge in economic uncertainty could negatively impact corporate earnings in the short term, the outside view considers historical equity performance following periods of extreme market volatility. In many cases, such volatility has historically been followed by strong equity market performance over the following year, suggesting potential opportunities for disciplined investors who maintain their focus during periods of uncertainty (see also The Upside of Fear).

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