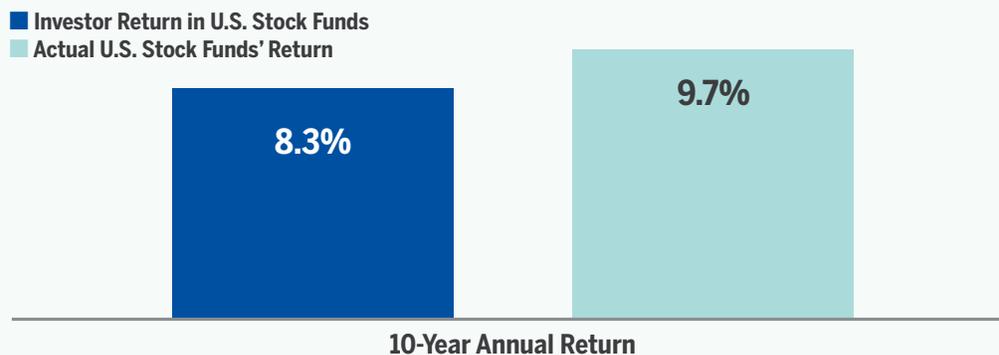


Making Better Decisions

Choosing wisely is paramount when it comes to achieving optimal investment results. Behavioral psychology teaches us several important lessons on how investors' minds operate. Although economics assumes humans behave rationally, relying too much on our own experience often prevents us from doing so. However, an important technique exists to help us make better decisions.

Performance Gap: Investors Have Underperformed



Source: *Mind the Gap 2018*; Morningstar for 10 years ended March 31, 2018.

- Based on data from Morningstar, investors have experienced a significant performance gap between their actual returns and official mutual fund total returns due to poor timing decisions. According to Morningstar, “investors large and small tend to sell after downturns only to buy back in after a rally,” which has led to a negative 137 bps per year gap over the past 10 years.
- How can an investor beat psychological pitfalls and navigate the market better? One answer is to use the outside view. The outside view relies on data from comparable situations and utilizes evidence from the experience of others, while the inside view is derived from a specific circumstance and uses evidence from one’s own experience (see [whitepaper “Looking Outside for Better Decisions”](#)).
- For example, when evaluating prospective equity returns, the inside view entails considering all of the current issues and trends in the economy and stock market as a typical TV pundit would do. The outside view, however, may look back at the past several decades of data and find that over 80% of the variation in 10-year annual equity returns is determined by the aggregate stock market price-to-earnings (P/E) multiple. This means that the stock market’s P/E multiple may be a better indicator of future stock market returns than the issues the inside view evaluates (see [Alger On the Money “Growth Stock Valuations in Perspective”](#)).¹
- From forecasting returns and determining asset allocation to tackling many of life’s other big decisions, using the outside view is often a better approach to decision-making.

¹ The price-to-earnings (P/E) multiple is a ratio for valuing a company that measures its current share price relative to its earnings per share.

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