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A Look in the Rearview Mirror

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April 2021

How surviving the COVID-19 market cycle (so far) has taught us to be better investors in the future.

While I could say that this past year has been a rollercoaster, that doesn't quite capture the true depth and range of emotions experienced over the last 13 months. A global pandemic, lockdowns, social distancing, working from home while also (for many) helping our children with school from home and not to mention the whiplash-inducing markets that made records with their speed both on the downside and upside, it's enough to make your head spin more than the Mad Tea Party ride at Disneyland. But now, with vaccinations well underway, case counts trending lower, and more and more businesses reopening, it feels like we are closer to the end of this madness rather than the beginning. However, before we get too wrapped up in the excitement tomorrow may bring, perhaps this is the opportune time to take a pause and reflect on the financial planning lessons we can take away from the history-making events of this past year.

Mind Games

Now, as equity markets continue to forge on to higher and higher highs, it's easy to look back on the market behavior in March 2020 and wonder, what were we thinking? In less than 30 trading days, we saw the S&P 500 Index fall over 35%, the fastest fall to bear market territory we have ever seen. In hindsight, we wonder, what was it that caused such a frenzy in the first place?

As I have written about before (Psychology and Money: A Primer on Behavioral Finance, July 2019), our brains often use shortcuts, or *heuristics*, to help us make decisions when presented with vast amounts of information. Unfortunately, as is the case with many shortcuts, they often lead to mistakes, or in this case, cognitive errors in our judgement and cause us to quickly come to a sub-optimal conclusion. While these cognitive errors are always present, they can be more easily recognized during extreme market events, which is what makes March 2020 a perfect case study to help us remember what we should always be on the lookout for, even during the good times.

Representativeness bias is the tendency to think that new information can be easily classified into stereotypes, and its close cousin, the *availability bias*, is the tendency to think that events that readily come to mind are more representative than they actually are. As markets fell in March of last year,

events such as the Great Depression and the financial crisis of 2008 readily came to mind. Yet, despite those being just two significant events in a 100-year timespan, many were quick to classify the market fall in March as the next "great one," as if any market correction were as bad as the two that readily came to mind. Moreover, it wasn't just our minds thinking about the similarities between these past events and the present circumstances, countless news articles did the same, which subsequently left us vulnerable to the *confirmation bias*, or the tendency to seek out new evidence that supports the original view. It was easy to cling to those ideas and take them as fact, assuring us of a grim fate that was, simply, an opinion.

Much like a snowball rolling down a hill, yet another bias, the *illusion of control*, or the tendency to feel like you have more control over outcomes than you actually do, made us feel like we could change this grim future for our portfolios, if we just took action. Many felt like if, perhaps, we changed our asset allocation, or just sold out of the market completely, we could save ourselves from the dire outcome we were so certain awaited us if we failed to act. In truth, our loss-averse brains, already taxed with trying to sort through what it meant to live-through a pandemic, were just trying to help us. But blindly following the train of thought initiated by these heuristics many times only leads us astray. So how do we arm ourselves against, well, ourselves?

Risk(y) Business

The good news is that education is one of the best shields against making cognitive errors in the future – just knowing they exist, as you do now by reading this article, is a huge step in the right direction. In addition, the best ways to mitigate the representativeness and availability biases specifically, are to develop a suitable long-term strategic asset allocation for the portfolio and follow both a disciplined research process as well as a documented Investment Policy Guideline (IPG), which is exactly what we do for you here at Osborne Partners.

Ensuring you have a suitable asset allocation means we have parsed out all the components of risk – risk perception, risk capacity, and risk tolerance – and put together an allocation that you can stick with both in the good times and in the bad. It's not just about how much risk you can take or want to take, but how much risk can you actually stomach when you see markets fall as they did last March.

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As you heard from us many times, the worst time to make a change in the portfolio is when markets have fallen drastically. Thus, your Portfolio Counselors constantly discuss your allocation with you and review your documented IPG at least every three years. By helping you mitigate these biases, this is truly one of the most important pieces of your portfolio success!

Goals-Based Planning

Thankfully, the illusion of control bias can also be mitigated by one of the items we already take care of for you in our normal course of business: applying probabilistic analysis to your portfolios and considering alternate (even worst-case) scenarios – aka, financial planning. We sometimes get so worked up in "chasing" the markets or fearing doomsday scenarios that we fail to take a step back and look at the bigger picture. What are we actually trying to accomplish here? Does your portfolio truly require the highest possible rate of return in order to be successful? And what would, in reality, be the effect on your long-term success if the market did endure a larger and longer correction? Might it be possible that you would still end up ok? Working through these scenarios with your Portfolio Counselor can provide you the peace of mind that any action you take, which sometimes means taking no action at all, is truly the right path for your portfolio.

While we begin to emerge from the whirlwind of this past year, I recognize that the coast is not clear yet. As I write this article, COVID has made its way to my family and reminded me that despite all the hope for a better tomorrow, the fight goes on, and will for some time. But we don't have to wait until the bitter end to glean some lessons from the COVID-induced market cycle. We may not be able to control how this virus continues to evolve, but a glance back in the rearview mirror can help ensure our portfolios (at least) are set up for success, come what may.

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