Investors Must Watch Out for Self-Fulfilling Prophecies

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When fear and uncertainty find their way into headlines, investors should ignore the herd and "stay the course."

Stock markets around the world rang in the new year with an old-fashioned selloff last week. In the U.S., the S&P 500, Dow Jones, Nasdaq and Russell 2000 indices all fell between 6–8 percent. Oil futures also succumbed to the downward pressures, dropping 11.02 percent. International markets such as China (down 8.10 percent), Europe (MSCI EAFE down 6.14 percent) and emerging markets (MSCI Emerging Markets down 6.79 percent) also ended 2016's first week of trading in the red.

	Weekly Total Return (%)	12-Month Total Return (%)
DJ Industrial Average TR USD	-6.13	-6.44
S&P 500 TR USD	-5.91	-4.8
NASDAQ Composite TR USD	-7.24	-0.81
Russell 2000 TR USD	-7.88	-11.33
MSCI EAFE GR USD	-6.14	-4.3
MSCI Emerging Markets GR USD	-6.79	-20.63
MSCI China IMI GR USD	-8.1	-15.84
Barclays US Aggregate Bond TR USD	0.64	0.52

**All data as of 1/8/2016. Past performance is not a guarantee of future results.*

The first week of 2016 was similar to what we experienced back in late August 2015, with unrest in the local Chinese market quickly spreading to markets around the globe. One key difference, however, is that the August selloff was sparked by a significant devaluation of China's currency — the yuan — and last week's rude awakening appears to have caught traders off guard, resulting in a swift spike in volatility. The CBOE Market Volatility (VIX) jumped nearly 50 percent during the week to 27.01, its highest level since late September.

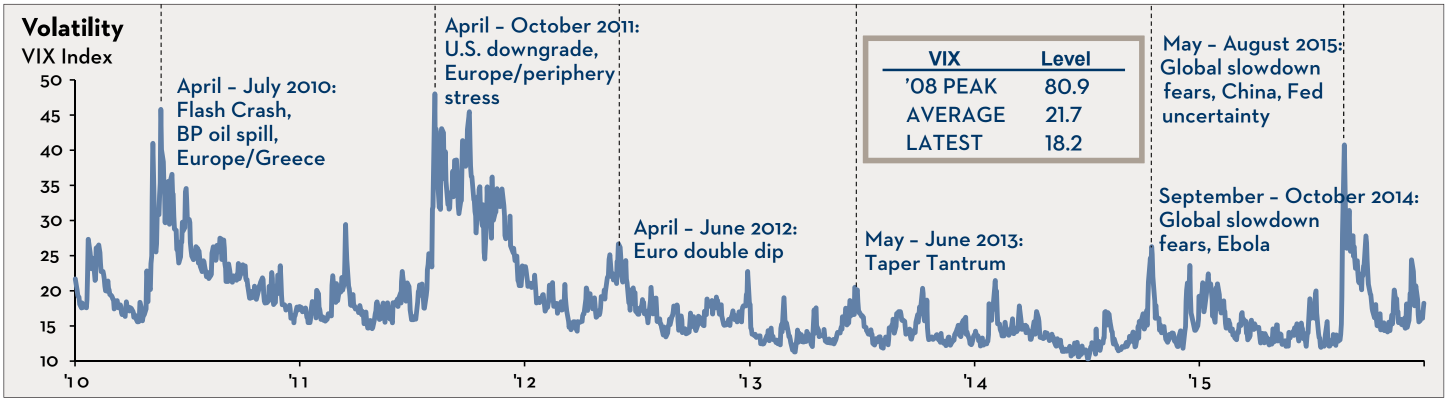
When volatility increases and clarity of information disappears, many investors sell first and ask questions later, making market corrections extremely vulnerable to the herding effect of human behavior and information cascades — a behavioral economics phenomenon in which individuals base their actions, such as investing decisions, on the actions of others, regardless of their own beliefs, knowledge, situations, etc.

As the number of sellers increases, so does the correction, creating what renowned sociologist Robert Merton called a "self-fulfilling prophecy."

Self-Fulfilling Prophecies

Self-fulfilling prophecies can be unnerving for investors, but they should not be unexpected. A central element of modern sociological, political and economic theory, a self-fulfilling prophecy is a process whereby a belief or an expectation, correct or incorrect, affects the outcome of a situation or the way a person or a group will behave. Merton once remarked about this topic, saying that "public definitions of a situation (prophecies or predictions) become an integral part of the situation and, thus, affect subsequent developments." As you can see from Figure 2, capital markets are often impacted by these self-fulfilling prophecies, especially when fears of a global economic slowdown and/or a geopolitical event occurs.

Figure 2: Fear and Volatility



Source: *FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Bottom) CBOE.*
Guide to the Markets – U.S. Data are as of Dec. 31, 2015.
Past performance is not a guarantee of future results.

In any swiftly occurring capital market selloff, investor fears are relatively basic human ones. These are fears such as losing property and possessions or perhaps the stock or bond market selloff means an economic contraction is imminent. They fear that some serious, irreversible, world-shattering unknown consequence will result if the selling continues.

Volatility levels have risen, and a notable re-pricing of risk is evident among domestic and foreign stocks, corporate and high-yield bonds, commodities, and emerging market currencies. With many stock indices down 5 percent or more in a matter of days, the mood for many investors could be described as nervous, concerned and confused.

There's no doubt that many, if not all, of today's investors still carry the psychological and emotional scars left by the Great Financial Crisis of 2008, and with "The Big Short" racking up more than $42 million at the box office, it's safe to say that some of those wounds to investor psyches have been reopened.

U.S. Economy Is Strong

Despite the negative environment for "risky" assets like commodities and emerging markets, the overall U.S. economy is in good health. Employment data released last week showed that the unemployment rate held at 5 percent in December — a level considered to be "full employment" — and nearly 300,000 jobs were added last month, the third-straight month above 250,000.

Housing prices remain strong in major markets around the country, and the rate of GDP growth was a respectable 2 percent (annualized) for the third quarter of 2015. In addition, consumer confidence levels remain strong, and spending remains elevated. In fact, it appears that American consumers have renewed their love for buying automobiles, purchasing 17.47 million light-duty vehicles in 2015[1] — a 6 percent jump from the previous year. It hasn't been all good news for the U.S. economy, however. Areas of the economy tied to the energy sector have retracted over the last 18 months as crude oil prices experienced a spectacular decline.

Despite the slide in oil, the U.S. economy does not appear to be either too much stress from other areas of global weakness, and various market and economic indicators are presently not showing signs of any impeding recession.

It's much more of a mixed bag when you look at the global economy. The most obvious and pressing concern is China. Local Chinese stock markets were the genesis of the current corrections, and many analysts find China's slowing rate of economic growth concerning. Others question the methods the Chinese government has used to prop up domestic banks, its stock market and its currency in order to push the country's economy away from investment dependency and toward a consumer-driven economy like we see in the developed world.

Fight Fears with Restraint and Thoughtfulness

Beginning back in June 2015, the sharp selloff in China has been a major contributor to investors selling stocks around the globe.

In *More Than You Know*, behavioral finance pundit and prolific author Michael Mauboussin points out that the stock market has no defined outcome and no defined time horizon. This means that it's actually the prices in the financial market that both *inform* its participants about the future and *influence* decisions.

When investors imitate one another or rely on the same information cascades, market efficiency is lost. The actions of some market players induce others to take the same course of action (buy or sell) based on the same signals from the environment without consideration that others are doing the same. Most importantly, they may be ignoring clear signals that it's in their best interests to refrain from taking the same action as a large group of others.

Six Things Investors Should Remember

1. Breathe, Don't Panic
2. Separate Fact from Opinion
3. Remember Your Long-Term "Why"
4. Discuss Your Fears and Concerns
5. Know Your Needs
6. Stay Diversified*

In some sense, information cascades are related to herd behavior, exacerbated during periods of extreme negative sentiment. "That unintended system-level consequences arise from even the best-intentioned individual-level actions has long been recognized," Mauboussin wrote in his second book, *Think Twice*. "But the decision-making challenge remains for a couple of reasons. First, our modern world has more interconnected systems than before. So we encounter these systems with greater frequency and, most likely, with greater consequence. Second, we still attempt to cure problems in complex systems with a naïve understanding of cause and effect."

Feedback loops involving investor confidence occur in the context of a complex social and psychological environment. Noted economist Robert Shiller stated in his famous book *Irrational Exuberance* that feedback loops are a vicious circle. "Underlying this feedback is a widespread public misperception about the importance of speculative thinking in our economy. People are accustomed to thinking that there is a basic state of health of the economy and that when the stock market goes up, or when GDP goes up, or when corporate profits go up, it means that the economy is healthier," Shiller wrote. "It seems as if people often think that the economy is struck by some exogenous maladies and that the stock market is just a reflection of those shocks. But people do not seem to perceive how often it is their own psychology, as part of a complex pattern of feedback, that is driving the economy."

While asset price bubbles represent one set of challenges, it's during times of negative feedback cycles that restraint and thoughtfulness must prevail. Merton concluded that the only way to break the cycle is to redefine the propositions on which the false assumptions were originally based.

Six Things Investors Should Remember

Summing up, it appears that a meaningful amount of action in the last few days reflected a rapid rise in investor uncertainty. Uncertainty means that investors will demand a higher risk premium — and, thus, lower asset prices — even in a world where economic fundamentals may be mixed but not necessarily collapsing. Hundreds of years of market history tell us that the current rash of uncertainty will be dispelled; however, the time it will take to do so is unknown. In the meantime, investors should expect that markets will potentially experience bouts of volatility over the next few months, and the ultimate timeframe for markets to find new levels to attract buyers is unknown.

During this cycle of uncertainty, investors should actively engage their financial advisors to gather their valued perspectives and re-examine or review their long-term financial goals and plan to reach them. Unless life circumstances have changed, it's important to ignore the herd and "stay the course."

When fear and uncertainty find their way into headlines, investors should remember these six things:

1. **Breathe, Don't Panic** — Making rash decisions during times of emotional stress often has negative consequences in the future and can potentially threaten long-term financial goals.
2. **Separate Fact from Opinion** — With thousands of "expert" voices in earshot, it's important to focus on the facts when reviewing stories on the market and the economy in the press.
3. **Remember Your Long-Term "Why"** — Why are you investing for the long term? Commonly, the reason is to set aside some current assets and income for future needs. Has that changed?
4. **Discuss Your Fears and Concerns** — Your financial advisor will help you navigate the short-term emotional swings of personal finance. The more you discuss your angst, fears and concerns with your advisor, the more they can tailor their professional guidance to your specific situation.
5. **Know Your Needs** — Investors should always know their needs for their money. If you need to use some of your investment assets in the short term for a major purchase or living expenses, it's wise to reassess where those monies are located and what they are invested in.
6. **Stay Diversified*** — When appropriate, a well-diversified portfolio can often alleviate concerns about being invested in the right place at the right time. Properly allocating your assets among various asset classes and diversifying your portfolio among several investment vehicles are meant to provide you with an efficiently diversified portfolio strategy that reduces volatility.

   **Asset allocation/diversification of your overall investment portfolio does not assure a profit or protect against a loss in declining markets.*

About the Author

Martin Landry, CFA, CFP®, CAIA, CIMA®, CIPM, AIF® – Portfolio Manager: Martin joined 1st Global in April 2010 with primary responsibility for due diligence, research, and monitoring of current and prospective investment managers. His portfolio management duties include implementation of fund and ETF changes within the IMS Select Portfolios and RMS Select Portfolios. Martin has more than 16 years of investment experience, including positions at GuideStone Capital Management, Bank of America and Merrill Lynch. He is a Chartered Financial Analyst® charterholder, a CERTIFIED FINANCIAL PLANNER™ professional, a CAIA designee, a CIMA® designee and a CIPM certificant, and he holds the Accredited Investment Fiduciary designation. Martin earned his MBA in management from the University of Texas at Tyler. He also has a B.S. in communications from Texas A&M University – Commerce.

About the Investment Management Research Group

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Sources:

[1]WardsAuto http://blog.caranddriver.com/boom-we-look-back-at-2015-u-s-auto-sales-the-best-year-ever/

Disclosures:

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The Barclays Municipal Bond index is a rules-based, market-value weighted index engineered for a broad representation of the tax-exempt bond market.

The Dow Jones Industrial Average is a price-weighted average of 30 blue chip stocks that are generally leaders in their industry.

The S&P 500 Stock Index is a widely recognized capitalization-weighted index of 500 common stock prices in U.S. companies.

The Nasdaq Composite Index is a capitalization-weighted index of all Nasdaq National Market and SmallCap stocks.

The Russell 2000 Index® is a U.S. equity index measuring the performance of the 2,000 smallest companies in the Russell 3000®, a widely recognized small-cap index.

The MSCI China Investable Market Index (IMI) captures large, mid and small cap representation of approximately 99% of the investable equity universe for China's mainland market. With 598 constituents, the index includes H, B, Red chip and P chip share classes.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following 21 developed market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.*

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.*

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Chicago Board Options Exchange (CBOE) Volatility Index (VIX) shows the market's expectation of 30-day volatility.

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