Sheaff Brock
Innovative Portfolios for Intelligent Investors™

The 3 Classes of Investors; Only 1 Can Afford to Avoid the Game

The head of behavioral science at *Morningstar*, Dr. Stephen Wendel, describes investors in simple terms: There are those wealthy enough to meet all their financial goals with cash and then there's everybody else.

Members of the first class need not bother themselves with market volatility; the other two classifications of investors face an unavoidable trade-off, Wendel explains. Type #2 stay in the market, running the risk of failing to generate sufficient returns to meet their financial goals. Type #3 derail their own goals through panicked selling. *Both panic selling and insufficient returns are unambiguously negative*, Wendel points out.

There have been two different ways investors have approached these competing demands caused by market volatility, the researcher observes:

- **The risk *capacity* approach:**
  You identify your financial goals, selecting (often with the help of advisors), the optimal investment mix to achieve those long-term goals. You measure capacity according to time horizon and liquidity needs, creating a "glide path" that moves assets from one asset mix into another (usually stocks into bonds) over time, as the date of need approaches.
- **The risk *preference* approach:**
  Typically your risk tolerance is assessment through some form of questionnaire that identifies where you fall on a scale from "conservative" to "aggressive." A mix of assets is selected based on those risk preferences. The irony, Wendel notes, is that risk-averse investors are typically placed in less volatile investments that have historically underperformed stocks!

We are very interested in Wendel's findings that no matter whether the investor was using the risk capacity or the risk preference approach, panic had a negative effect. As Sheaff Brock Managing Director Dave Gilreath stresses, disciplined investors focus on building long-term wealth, ignoring short term "noise."

Such a disciplined approach is far easier described than done, to be sure, and Wendel went so far as to cull specific tidbits of anti-panic techniques and tools from the research literature, including:

- Avoid frequent price updates on your portfolio holdings
- Change how you interpret your own body's response to situations, reappraising rather than ignoring your own emotions.
- Refer to your written financial plan or investment policy statement during volatile times.
- Make it more difficult to act hastily by requiring that your spouse sign off on each decision, or by adding verification procedures during online portals.
- Request a delay period between a decision and its execution.

In medicine, a "false positive" is a test result which indicates that a particular illness is present when, in reality, it is not. In investing, a "false negative" happens when some financial news triggers an out-of-proportion fear reaction. If you are not in that first class of investors (those who can afford to totally avoid investing in the market), our advice to you is this: **don't allow panic to derail your own financial future!**