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INVESTMENT MANAGEMENT

Taming animal spirits

Fundamental Index™ strategies may help manage "animal spirits" by mitigating the effects of the anchoring and overconfidence biases, which can emerge during momentum-driven market rallies.

Insights from Omar Aguilar

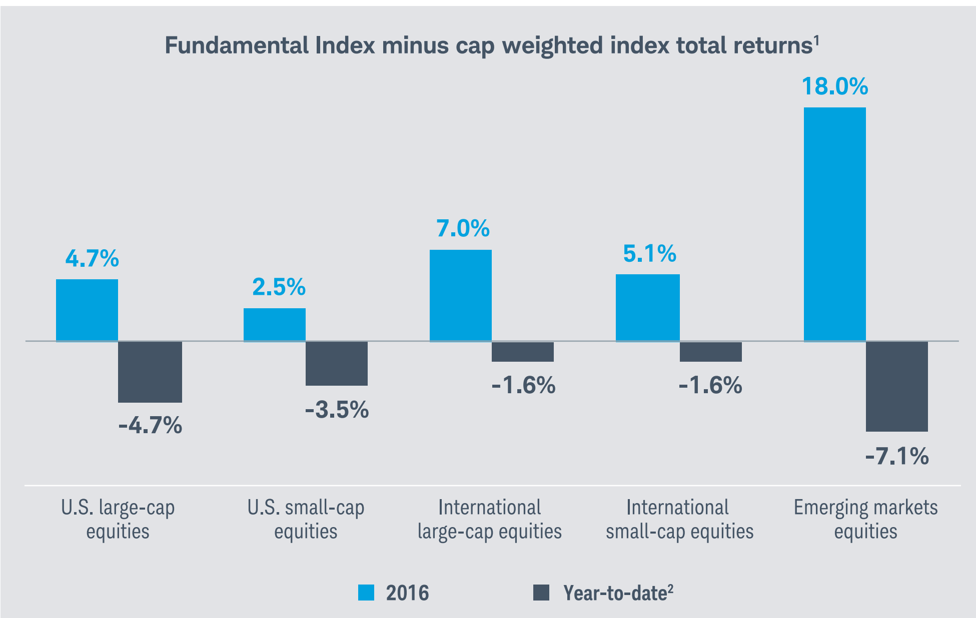
CIO, Equities and Multi-Asset Strategies

Key takeaways:

- Animal spirits seem to be driving this year's bullish run in U.S. equities.
- The anchoring and over-confidence biases could be feeding the market's animal spirits this year.
- Fundamental Index strategies may help manage animal spirits by potentially reducing the effects of behavioral finance biases.
- Fundamental Index strategies could enjoy tailwinds if short-term mean reversion occurs.

Animal spirits may have played a role in the equity market's performance in 2017.

Animal spirits—a term from the late British economist John Maynard Keynes—seem to be driving major U.S. stock market indexes to record highs this year. Behavioral finance biases often emerge in momentum-driven periods like the current one, as emotions potentially supersede the benefits of a more disciplined, fundamental approach to stock selection. This environment led to a performance disparity between Fundamental Index and cap weighted index strategies for the first nine months of 2017, as shown below.



Sources: Bloomberg; Charles Schwab Investment Management.

Anchoring and overconfidence seem to be supporting the market's momentum.

The anchoring and overconfidence biases are behavioral finance factors that seem to be feeding the market's animal spirits. Overconfidence fosters the conviction that our insights are uniquely valuable, while anchoring is a fixation on initial data when subsequently gauging information. Both biases may be tied to the equity market's current rally, as investors have anchored on the president's campaign promises and confidently driven stocks higher amid expectations that these promises will be fulfilled.

Fundamental Index strategies may help manage animal spirits.

The Fundamental Index methodology systematically breaks the link with price- and market-driven emotion, helping to manage animal spirits by potentially reducing the effects of behavioral finance biases like anchoring and overconfidence. Given the current narrow market leadership and arguably stretched valuations among select stocks, short-term mean reversion seems increasingly possible. Mean reversions tend to reset asset valuations over time and might create tailwinds for Fundamental Index strategies.

Put the Biagnostics™ process to work in your practice.

Identify and treat your clients' investing biases

Biagnostics is a framework to help advisors incorporate behavioral finance into their practice. The proprietary process is designed to create an emotionally and financially customized client experience by addressing behavioral biases and generational/life-stage challenges. With Biagnostics, advisors can use the principles of behavioral finance to identify and mitigate potential biases and trip wires in order to build better client experiences.

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Past performance does not guarantee future returns.

There can be no assurance that the Fundamental Index strategies will achieve their desired outcomes. Each investing strategy involves its own set of unique risks and benefits.

[1] For the purposes of this communication, the indexes used to represent the performance of Fundamental Index strategies included: "U.S. large-cap equities"–the Russell RAFI US Large Co. Index; "U.S. small-cap equities"–the Russell RAFI US Small Co. Index; "International large-cap equities"–the Russell RAFI Developed ex US Large Co. Index (Net); "International small-cap equities"–the Russell RAFI Developed ex US Small Co. Index (Net); "Emerging market equities"–the Russell RAFI Emerging Markets Large Co. Index (Net). The indexes used to represent the performance of cap weighted index strategies included: "U.S. large-cap equities"–the S&P 500® Index; "U.S. small-cap equities"–the Russell 2000® Index; "International large-cap equities"–the MSCI EAFE Index; "International small-cap equities"–the MSCI World ex USA Small Cap Index; "Emerging markets equities"–the MSCI Emerging Markets Index.

[2] For the YTD period ended 09/30/2017.

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Indexes are unmanaged, do not incur fees, and are unavailable for direct investment.

Diversification and asset allocation strategies do not ensure a profit and do not protect against losses in declining markets.

Small cap funds are subject to greater volatility than those in other asset categories.

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