Charles Schwab Investment Management

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Perspective on global equity markets through a behavioral finance lens

The availability bias

Spring 2018

Do your clients always evaluate data and facts objectively before reaching a conclusion? Behavioral finance suggests otherwise, revealing that human nature often leads us to employ a far less calculated approach and instead revert to mental shortcuts. These shortcuts, or mental heuristics, enable a quicker decision-making process when attempting to solve problems or develop solutions, particularly to everyday situations.

The availability bias is a prime example, reflecting our innate tendency to believe that our recollections of events are accurate and true, and that anything falling outside of these recollections should be discounted in accuracy, probability, and relevance. However, what we remember is potentially influenced by our beliefs, expectations, and feelings, as well as the frequency of exposure to an issue due to social or mass-media influences.

In this edition of our quarterly behavioral finance insights, we discuss the availability bias and its generational effects, while providing key takeaways to help advisors discuss the recent return of market volatility with clients.

Key takeaways:

- The availability bias can substantially influence our perceptions, often in subtle ways.
- Market volatility has recently risen to levels more in line with long-term historical averages after two years of comparative complacency.
- Baby Boomers seem particularly susceptible to the availability bias, and their recent reactions to the February selloff illustrate this point.
- Millennials seem more interested in cryptocurrencies than equities after the market's recent behavior.
- Looking ahead, volatility may be here to stay, underscoring the importance of speaking with clients about the benefits of portfolio diversification.

Euphoric start to 2018

Last year's remarkable performance by stocks made this year's euphoric start possible and has important implications for your clients. Still in focus for Baby Boomers is probably that the S&P 500® Index enjoyed a record 12 consecutive months of positive total returns in 2017, as momentum drove the markets to one record high after another. Political unrest in Washington, D.C., terrorist attacks in the U.K., and elevated tensions with North Korea seemed to have little effect on record levels of consumer and investor confidence. A year of historically low average volatility was the result and is captured in the Cboe Volatility Index® (VIX Index®) chart below. Included in the chart is a low-volatility average line that reflects the market's complacent behavior in 2016 and 2017, and over the preceding three years.

The chart's long-term average line is particularly noteworthy. This line escapes the boundaries of the availability bias and illustrates a more realistic view of the market's performance over a longer-term period that included multiple major market shocks. This line seems far more representative of what we believe that your clients might experience going forward.

Market conditions revert to the mean

How your Baby Boomer and Millennial clients perceive current market conditions may be based in part on how greatly they are being influenced by the availability bias. Given the recent return to normalcy in market volatility levels amid rising inflation expectations, longer-term rates, and geopolitical tensions, now may be a good time to ensure that your clients' expectations are properly aligned with current economic conditions.

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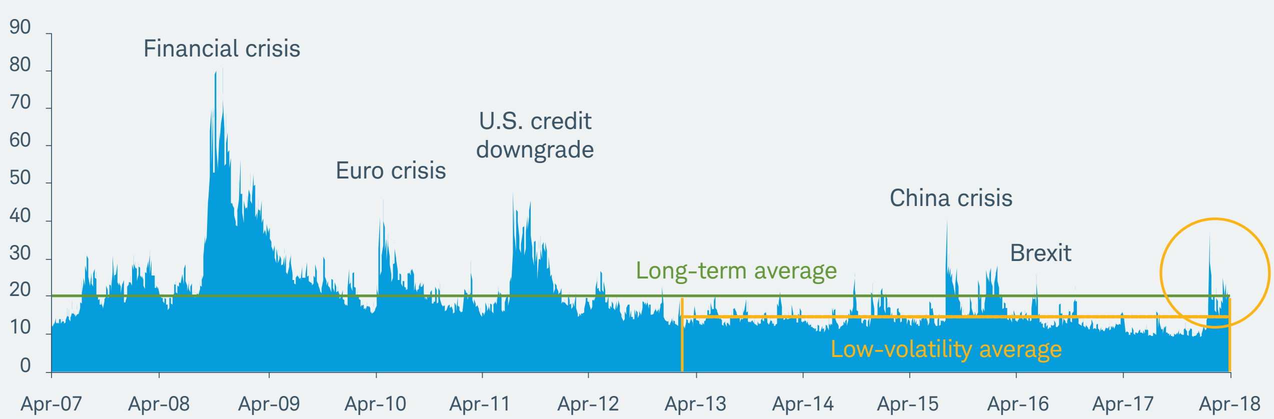
A solid foundation remains in place...

Although 2018 feels quite different than 2017, the underlying economic fundamentals have changed very little. In particular, tailwinds from tax cuts, favorable U.S. economic growth, solid corporate earnings, and increased capital expenditures made it possible for pro-cyclical sectors like Consumer Staples, Financials, and Materials to perform well early this year. Internationally, economic growth in Europe and many emerging markets continue to benefit from synchronized stimulus efforts by central banks, with prospects continuing to improve.

...but the bull market's final phase is likely here

In spite of these positive undercurrents, the final phase of the current U.S. economic cycle may have arrived. The Federal Reserve's accommodative policies are transitioning to a tighter monetary stance designed to keep inflation under control, a process that will eventually start to reduce the availability of funds and corresponding capital expenditures by firms that can drive profit growth. At the same time, new fiscal stimulus is projected due to President Trump's recent cut in corporate tax rates to 21%. Little wonder then that longer-term bond yields rose in late February alongside inflation expectations, fueling increased market volatility that could continue for the foreseeable future.

VIX Index



Sources: Charles Schwab Investment Management; Bloomberg; long-term average from 04/15/07 to 04/15/18; low-volatility average for the five years ended 04/15/18.

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Baby Boomers upped their ante

Volatility is nothing new to Baby Boomers, a generation that was heavily invested during the technology bubble of the late 1990s and more recent real-estate bubble. Boomers own the majority of the U.S. stock market through various investment vehicles, so their investment decisions tend to have a pronounced effect on the financial markets. During both the tech and housing-market bubbles, for example, Boomers often maintained their investment strategies beyond fair-valuation levels and ignored the growing evidence of market dislocations.

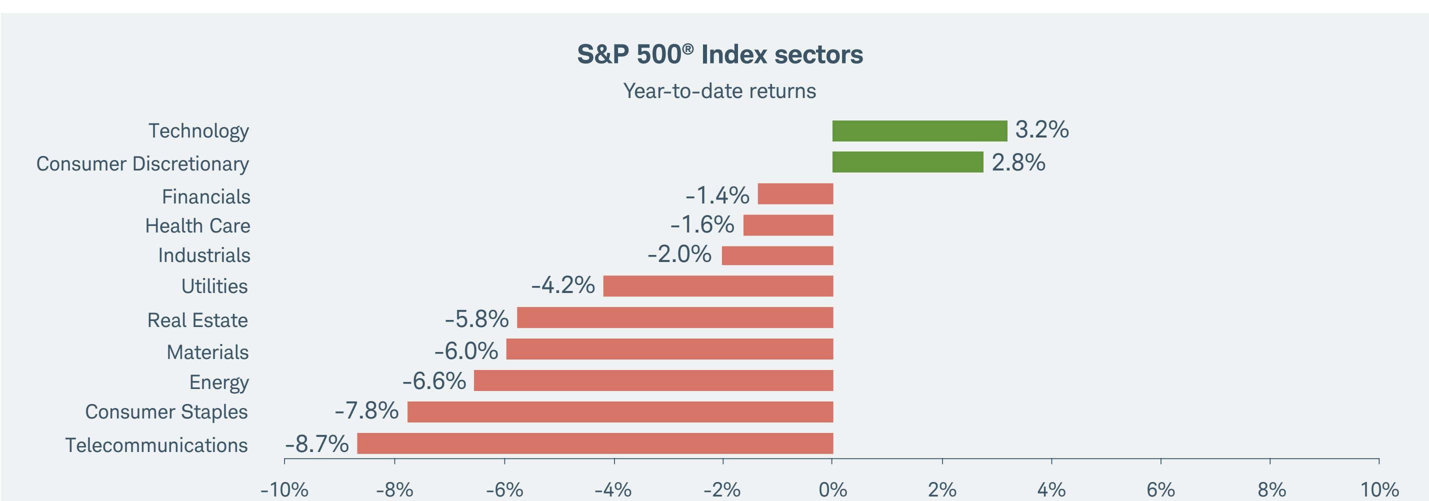
The stock market's recent volatility spike represented a fresh example of such optimistic behavior. Historically speaking, a spike in volatility such as the one experienced early this year would have fueled an immediate flight to quality, causing Treasuries to rally at the expense of risk-based assets. Instead, the availability bias came into play, helping to keep many Baby Boomers centered on last year's upbeat, low-volatility environment and looking at the event as an opportunity to increase their equity allocations. Unfortunately for Boomers, ongoing volatility seems far more likely over the foreseeable future than does a reversion to euphoric market conditions.

Millennials followed a path less traveled

Compared with the all-in approach of many Baby Boomers, Millennials seemed to view the recent return to normal market volatility as one more reason to steer clear of stocks for the immediate future. Millennials tend to be far more skeptical by nature than Baby Boomers, The Silent Generation, or Generation-X. Millennials have demonstrated a remarkable tendency to make data-driven decisions and be less interested in global equity markets than in cryptocurrencies, for example. As a result, Millennials are collectively taking more of a wait-and-see approach regarding what the future holds for equities. Generation-X investors seem to fall somewhere in between the two generational extremes provided on one side by Baby Boomers and on the other by Millennials.

Generational takeaways and action items

As market conditions continue to evolve, speaking with your Baby Boomer clients about countering any potentially negative effects of the availability bias with a realistic appraisal of current market conditions may become important. The chart below might help with such a conversation, illustrating that year-to-date returns for most sectors have turned decidedly negative, a sharp shift from 2017. With this point in mind, ensuring that your clients are comfortable with their current asset allocations and risk-return profile might be a prudent step in case volatility lingers. For your Millennial clients, remember that their current generational mindset may require a longer period of time to become comfortable with the recently elevated levels of volatility. Conversations that help frame the recent return to market volatility as a reversion to mean market behavior might provide relative context.



Sources: Charles Schwab Investment Management; Bloomberg; year-to-date returns through 04/15/18.

On the horizon

When speaking with your clients regarding the availability bias, another point potentially worth discussing is the importance of staying the course with a disciplined investment approach. When your clients make decisions, they tend to be swayed by what they remember, which can be affected by beliefs, emotions, and feelings, as well as attention in mass media. Their recollections of portfolio-related considerations and events are therefore predisposed to be less than perfect. This is where your influence as an advisor can play a pivotal role in helping your clients understand how behavioral finance biases can potentially influence their decision-making process.

Looking ahead regarding the equity markets in general, we believe that select stocks and sectors could prove increasingly vulnerable as the Fed continues to hike short-term rates in the face of ever-tighter employment conditions. Specifically, bond-proxy sectors like REITs, Utilities, and Consumer Staples are likely to face headwinds as rates continue to rise, given that short-term bond yields are becoming increasingly competitive with dividend yields. By comparison, we believe that procyclical sectors like Technology, Health Care, and Financials are better positioned to benefit from the recent tax revisions, stock buybacks, and increased capital expenditures in the current environment.

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