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Insights from Omar Aguilar

CIO, Equities and Multi-Asset Strategies

Perspective on global equity markets through a behavioral finance lens

The normalcy bias: A break from reality

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Have your clients occasionally seemed disconnected from market realities this year? Behavioral finance may be able to help explain why. Studies have shown that when faced with particularly unwelcome circumstances, investors have a deeply ingrained tendency to downplay the possibility and severity of negative events. This cognitive disconnect is known as the normalcy bias, or more informally as the "ostrich effect." The unexpectedly strong first-quarter performance of U.S. stocks—with the S&P 500® Index generating its largest quarterly gain since 2009—has all the hallmarks of having encouraged a classic heads-in-the-sand environment.

In this edition of our behavioral finance insights, we discuss how the equity market's early year rebound may have helped to trigger the normalcy bias, offer thoughts about generational susceptibilities to this bias, and provide actionable guidance to help advisors better prepare their clients for the evolving market environment.

A December to forget

To appreciate the influential role recently played by the normalcy bias, recall the challenges that faced the U.S. stock market in the final weeks of 2018. From the longest recorded U.S. government shutdown to the fast-fading effects of 2017 tax cuts, a myriad of geopolitical stressors and weakening data points dragged the S&P 500 Index to its worst December since the 1930s. While the speed and severity of this correction caught many by surprise, the catalyst was well known: Simply put, the outlook had suddenly deteriorated.

Key takeaways

- U.S. stocks have enjoyed a spectacular start to 2019, but share prices and key fundamentals may have become disconnected.
- The normalcy bias could be behind this disconnect—this behavioral finance bias can slow your clients' responses to unexpected market events.
- Baby Boomers tend to be far more susceptible to the normalcy bias than Millennials.
- The Fed pausing on further rate hikes factored into the early year rebound in stocks, helping to trigger the normalcy bias.
- Now may be an opportune time to talk with your clients about preparing their portfolios for greater market volatility.

Then something else surprising happened. The Federal Reserve (Fed), at its December policy meeting on interest rates, unexpectedly announced that it would press pause on tightening monetary policy for the indefinite future. Amid this shifting backdrop, the S&P 500 Index quickly changed direction, retracing almost all of its December losses by late January. By late March, the index was within striking distance of its pre-October 2018 highs, as demonstrated in the chart below.

Fixation on the Fed

Scientists speculate that the normalcy bias is a function of the way in which the brain processes new information during a crisis. The brain essentially slows when stressed, and while struggling to find an acceptable response, it tends to find and fixate on a single default solution. This helps to explain why the Fed's December announcement generated such a dramatic market reaction. To the Fed, the decision was consistent with its pledge to be data-driven regarding its official mandates to balance employment and inflation considerations, alongside an unofficial mandate of supporting financial market stability. From a behavioral finance standpoint, this was a prime environment for the normalcy bias. Ingrained over a decade of such Fed interventions, it was as if a portion of the market's cortex shouted: *See, everything is back to normal!*

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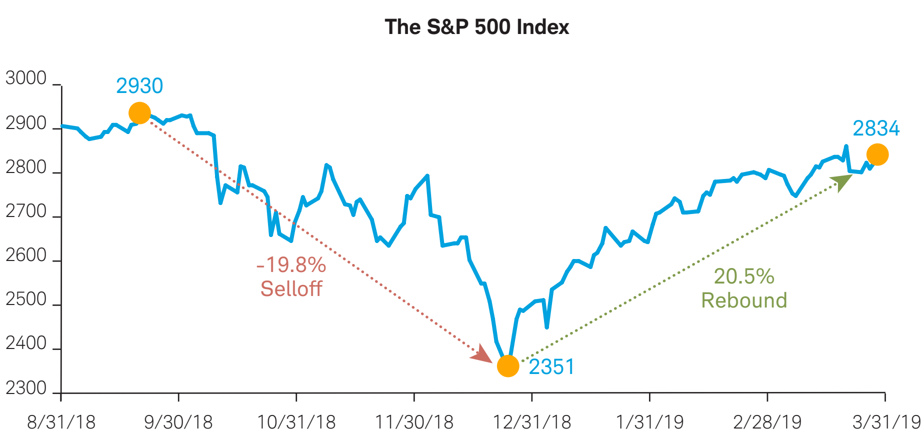
Help your clients re-anchor on reality

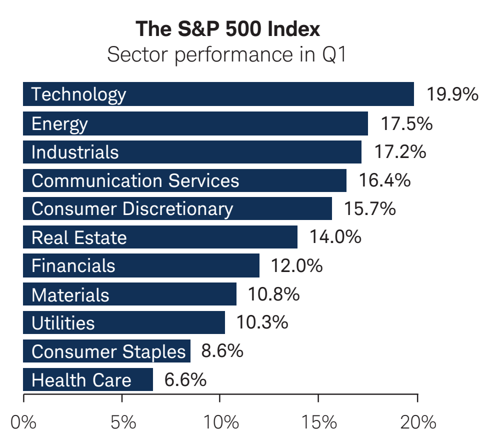
At such times, it can be especially important for advisors to objectively counterweight biases and help clients evaluate their risks more rationally. Advisors might start by asking clients: Apart from the Fed's stance on rates, how much of the environment has really changed since December? Yes, the government shutdown is behind us, and there is some optimism around the U.S. trade war with China, but virtually all the other issues that factored into the late-year selloff remain as much in play today as they were in 2018.

If anything, some of the most relevant U.S. data points have continued to deteriorate. Corporate earnings per share, which grew by approximately 27.5% on a year-over-year basis in last year's third quarter—as the corporate tax

A remarkable equity rebound in early 2019

The bullish equity market rebound early this year may have triggered the normalcy bias.





Sources: Charles Schwab Investment Management; Bloomberg. Data from 08/31/18 to 03/31/19.

Sources: Charles Schwab Investment Management; Bloomberg. Data from 12/31/18 to 03/31/19.

cut invigorated the economy—grew by less than one percent in this year's first quarter. Meanwhile, after an impressive 4.2% year-over-year annualized pace in the second quarter of 2018, gross domestic product (GDP), is forecasted to have slowed to roughly half this pace during the first three months of 2019, as shown in the chart below. While this rate would be roughly in line with the post-financial crisis average, today the U.S. represents only 20% of the global economy. As a result, with China, Europe, and Japan all slowing even more rapidly than the U.S., an added concern is that weakened global demand could still cause domestic economic activity to slow even further.

No imminent recession...*yet*

Nevertheless, we do not believe that the U.S. is in immediate danger of sliding into a recession. In fact, with unemployment still at record lows, the odds of a recession in 2019 remain quite low in spite of the recent and temporary yield curve inversion, where 10-year Treasury yields slipped below 3-month T-bill yields for the first time in 12 years. Historically, this has often been a harbinger for a subsequent recession. However, even if this pattern holds, the historical lag would most likely have the next possible recession starting no sooner than at least 2020.

From a generational standpoint, Baby Boomers are probably the most in need of your help.

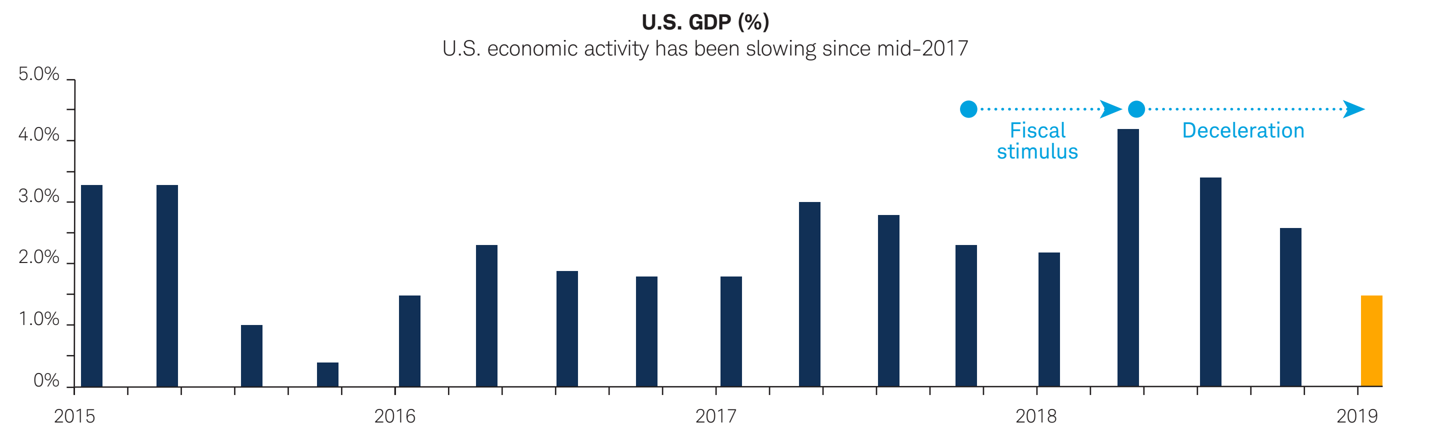
Baby Boomers: Highly susceptible to the normalcy bias

What it does mean is that providing your clients with options for better aligning their thinking—and their portfolios—with the realities of investing in 2019 may make considerable sense.

From a generational standpoint, Baby Boomers are probably the most in need of your help. Predisposed to overconfidence and optimism, boomers have survived multiple investing downturns. For many, this has only reinforced their predisposition toward being affected by the normalcy bias. It may have also left many overexposed to an untimely erosion in capital that they might not be as quick to recover from next time, especially as they approach retirement.

The recent rise and fall of U.S. GDP

The U.S. economy has been slowing as last year's fiscal stimulus continues to fade.



Sources: Charles Schwab Investment Management; Bloomberg. Quarterly gross domestic product, data from 12/31/14 to 03/31/19.

Many of these clients likely used the December selloff to increase their exposure to Technology stocks that have dominated the market in recent years. The recent recovery of many of these stocks may present a good opportunity to pull some of those gains off the table. Consider speaking with your clients about adopting a “barbell” approach to their equity allocations: leaving a portion in Technology and other growth-oriented stocks, while moving another large portion into more defensive high-quality sectors.

Millennials: Not so much

At the other end of the spectrum are Millennials. With their formative years bookended by the dot-com bust and the Great Recession, Millennials tend to be inherently more risk-averse than the boomers, and inherently less affected by the normalcy bias. For many, the late 2018 selloff likely just confirmed their suspicions about the current market—and increased the attractiveness of cash now that short-term yields have backed up above 2%. However, Millennials’ resistance to the normalcy bias carries its own risk, namely the risk they will not be able to sufficiently grow their assets. For these clients, the same barbell approach can appeal to their sense of caution, and help persuade the more cynical among them to maintain the market exposure needed to reach their long-term financial goals.

On the horizon

The normalcy bias is just part what makes us human, but behavioral finance biases do not have to dictate your clients’ decisions. Studies show that people who pre-plan ahead of natural disasters stand a much better chance of overcoming the normalcy bias. If we think of the previously described market backdrop as the ultimate late-cycle “grab-and-go” kit, the best time to have such discussions is now, while markets are still reasonably calm, not after volatility fully returns and investors re-awaken to the long-term realities of investing. A carefully balanced portfolio is the kind of measured, heads-*out*-of-the-sand approach that we think could help keep your clients in tune with the present environment.

Omar

Omar Aguilar, PhD
Chief Investment Officer, Equities
Charles Schwab Investment Management

About the author

Omar Aguilar is Chief Investment Officer (Equities and Multi-Asset Strategies) of Charles Schwab Investment Management, Inc. (CSIM), a subsidiary of The Charles Schwab Corporation. Aguilar joined CSIM in 2011 and is responsible for equity and asset allocation mutual funds, ETFs, and separately managed accounts. Aguilar has more than 20 years of broad investment management experience in the equity markets, including managing index, quantitative equity, asset allocation, and multi-manager strategies. Aguilar received a BS in actuarial sciences and a graduate degree in applied statistics from the Mexico Autonomous Institute of Technology (ITAM). He was a Fulbright scholar at Duke University’s Institute of Statistics and Decisions Sciences, where he earned his MS and PhD.

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