Investment Management

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Insights from Omar Aguilar

CIO of Passive Equity and Multi-Asset Strategies

Perspective on global equity markets through a behavioral finance lens

The recency bias: A rearview mirror fixation

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Some of your clients may be expecting outsized market returns in 2020, confident that 2019's remarkable results will replicate themselves this year. In behavioral finance terms, this cognitive behavioral finance trap is known as the recency bias. The recency bias may also cloud your clients' views of the distant past, potentially convincing them that negative events were one-time-only challenges that will never repeat. Underlying these reactions, how the recency bias may manifest itself among your clients partially depends upon their formative investing experiences, which differ substantially between Baby Boomers and Millennials.

In this edition of our behavioral finance insights, we discuss the recency bias and offer actionable ideas that may help your clients generate better long-term financial outcomes, while potentially enhancing your value proposition.

Key takeaways

- The recency bias is the tendency to consider recent events as indicative of future outcomes.
- This cognitive behavioral finance effect can manifest itself in different ways from one generation to another.
- Baby Boomers may show recency bias effects in 2020 by expressing a preference for overweighting equities.
- Millennials may show recency bias effects by holding more safety assets, possibly reflecting their skepticism about equities.
- Consider reevaluating the risk appetites of your clients and employing a systematic, disciplined portfolio construction process.

Retrospective on a recency biased year

The recency bias featured prominently in 2019's market behavior. This bias likely led some investors to add to their equity positions early in the year, when the Federal Reserve unexpectedly pivoted from tighter monetary policies and expectations for raising short-term interest rates, to stimulating U.S. economic growth by cutting rates, instead.

For other, more risk-averse investors, memories of the nearly 19% drop by the Dow Jones Industrial Average from early October 2018 to late December of 2018 (see the chart below) weighed far more heavily on their portfolio decisions. Leftover effects of this selloff appeared to be a dominant concern for such investors as uncertainties around trade tensions with China, Mexico, and Europe repeatedly surfaced in 2019.

Late arriving investors largely missed out

As a result, many of these risk-averse investors seemed to retrench in May, and then again in July and September. As 2019 wound to a close, and tariffs were paused as the prospect of a phase one trade deal with China materialized, many of these reluctant investors finally returned to U.S. stocks. Unfortunately, they had already missed out on most of last year's historically outsized returns.

> Foundational investing experiences tend to play a leading role in shaping a given generation's overall perspective where relative levels of potential risk and return are concerned.

This outcome demonstrates the potentially negative effects that behaviorally biased investment decisions may have on your clients, reducing their opportunity to achieve long-term financial success.

A generational dispersion of side effects

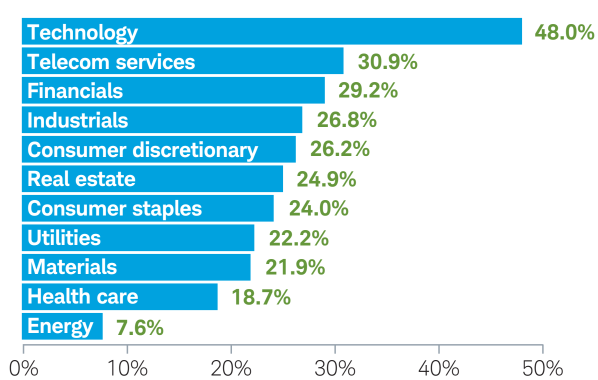
As these divergent results illustrate, recency bias effects are not always straightforward. Foundational investing experiences tend to play a leading role in shaping a given generation's overall perspective where relative levels of potential risk and return are concerned.

Equity markets

After a volatile 2018, equity markets recovered in 2019.

Dow Jones Industrial Average **2019 total return:** +22.34%

S&P 500® Index sector total returns in 2019



Sources: Charles Schwab Investment Management; Bloomberg. Data as of 12/31/19.
Past performance is no guarantee of future results. Indexes are unmanaged, and do not incur fees, and it is not possible to invest directly in an index.

Baby Boomers jumped in with confidence

We believe that Baby Boomers (1946-1964) were among the first to add to their equity positions last year as stocks surged in the first quarter of 2019. In spite of weathering several major market crises during their formative investing years, Baby Boomers enjoyed a more than decade-long bull market early on in their investing lifetimes before weathering several major financial market crises (see the chart below, at left). Last year's remarkable stock market results may have even reinforced their predisposition toward being active, potentially overconfident risk-takers.

Millennials waited to join the party

The formative market experiences of Millennials (1981-1996) occurred during the fallout from the dot-com bust, the 2008/2009 global market collapse, and the Great Recession. Many Millennials watched their parents endure sharp retirement account losses and financial hardships while struggling to pay the bills (see the chart below, at right). Millennials therefore tend to be somewhat risk-averse where equities are concerned. The four interest rate hikes by the Federal Reserve in 2018, increased market volatility, and double-digit decline by U.S. equities late in 2018 likely reinforced their inherent aversion toward stocks.

Generational risks diverge in 2020

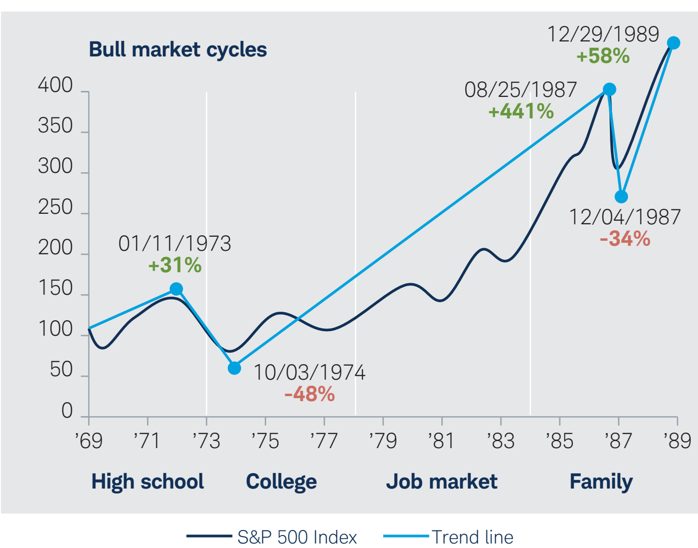
Looking forward to the remainder of this year, Baby Boomers and Millennials face different risks. Baby Boomers may think that a repeat of 2019 is likely, confidently pushing them toward an over allocation in momentum-based strategies that generally outperformed in 2019. Given the lateness of the business cycle, historic age of the current bull market, and that most Boomers are in or near retirement, such an over-allocation might represent a material risk to their chances for financial success. A reversion to the mean in valuations—which are historically high by many measures—is an example of a drawdown risk from which their portfolios may have insufficient time to recover. In contrast, Millennials may be overexposed to cash. By underweighting stocks, Millennials may be limiting longer-term portfolio growth, an effect that would become amplified if their stock allocations shrink over time and their portfolios become more conservative on the road to retirement.

A budding global rebound in the works

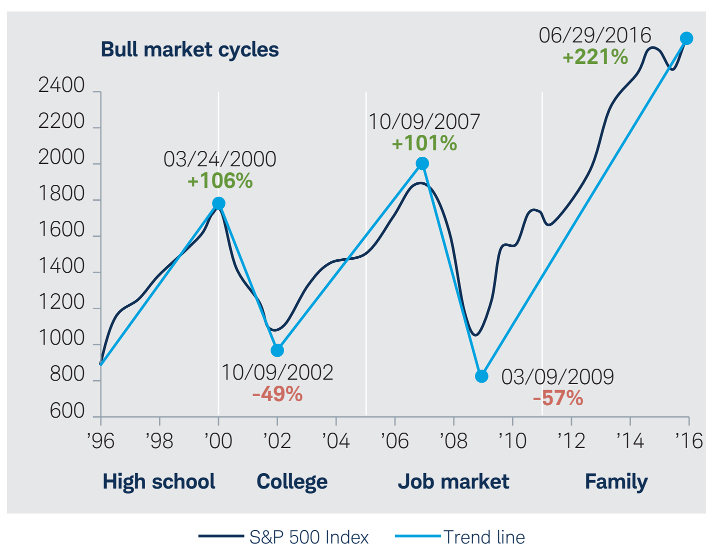
Global growth may be starting to rebound. Trade tensions are generally subsiding, manufacturing seems set to bottom out in Europe and Japan, international labor markets remain generally strong, and central bank policies worldwide remain accommodative. Meanwhile, in the U.S., economic activity seems likely to continue at a relatively modest pace.

Foundational investing experiences of Baby Boomers and Millennials

What Boomers **"know"**



What Millennials **"know"**



Sources: Charles Schwab Investment Management; Bloomberg. Illustrative research samples.
Past performance is no guarantee of future results. Indexes are unmanaged; do not incur management fees, costs, and expenses; and cannot be invested in directly.

Final takeaways to share with clients

With this backdrop in mind, consider discussing the following opportunities with your clients.

The first potential opportunity would be to rebalance their portfolios toward their targeted long-term allocations. In light of 2019's market performance, many of your clients may be overexposed to growth-oriented equities. While rebalancing, think about evaluating asset classes that have lagged U.S. large-caps in recent years and that might benefit from a reversion to the mean. Smaller-cap U.S. stocks and international developed market equities are two potentially opportunistic examples. Also, remember that systematically rebalancing each year may reduce the probability of your clients being negatively affected by behavioral finance biases.

Second, evaluate whether your clients are experiencing the fear of missing out (FOMO). The belief that there is no alternative (TINA) to stocks may also be affecting some clients. If either of these biases is in evidence, discussing the unlikely chances for a repeat of 2019 returns for U.S. stocks in 2020 might help. Reminding clients of the potential long-term benefits of diversification and non-market-cap equity opportunities like strategic beta strategies may also result in productive conversations.

Third, remember that the recency bias is generationally nuanced. Help your Baby Boomers clients see their portfolio's potential vulnerability if they overweight equities with already overextended valuations, and help Millennials overcome their inherent risk aversion to stocks. Millennials holding out for a correction before rebalancing might reconsider whether to keep waiting after a discussion about the potential benefits of dollar-cost averaging and their long-term investment horizons.

Omar

Omar Aguilar, PhD
Chief Investment Officer of Passive Equity and Multi-Asset Strategies
Charles Schwab Investment Management

About the author

Omar Aguilar is Chief Investment Officer (Passive Equity 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.

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

The S&P 500 Index is designed to measure the performance of 500 leading publicly traded companies from a broad range of industries.

Please visit schwabfunds.com/glossary for additional index information. Indexes are unmanaged, and do not incur fees, and it is not possible to invest directly in an index.

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