Avoiding the Negativity Vortex

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For years, I've kept a small piece of paper tacked to the wall of my office that reads:

"It often sounds smart to be negative. But it almost always pays to be positive."

Negativity often masquerades as intellect. Seeing the glass half empty is perceived as analytical, cautious and sophisticated. It's a sales technique that captivates because we want to believe there's a perfect solution – even when we know there is no such thing. For someone to study every potential risk and prepare for the worst seems wise when considering a financial plan.

Experience, however, reveals that repeatedly proving a dire prophecy is extremely rare. Instead, optimism tends to win over the long term. Yet, we view time in short increments and judge success — or failure — too quickly. Hence the fixation on negativity.

Finding Balance During Market Gyrations

Myopic Loss Aversion refers to an investor's tendency to fixate on short-term losses rather than the potential for long-term gains. This tendency is exacerbated by frequently checking account balances because, simply put, investors experience more volatility when they see more movement more often.

Consequently, this behavior leads individuals to opt for overly conservative investments. They prioritize avoiding perceived immediate risk over pursuing higher returns likely over a longer time horizon. Extending your time horizon can contextualize short-term adverse outcomes as temporary setbacks.

The inherent volatility of equity markets means that drawdowns are not just possible but a guaranteed aspect of investing. A lack of understanding of the quantified impact a market drawdown has on your capital needs is a primary reason most investors may respond emotionally during times of stress. Anyone masking "advice" as an ability to predict an impending recession or drawdown, allowing those who follow them to get out of the way just in time, is overestimating their ability to time the market accurately. Investors tend to sell out of the market too early and buy back in too late.[1,2,3]

There's often a significant difference between perceived risk tolerance, what you think or hope you can handle, and actual volatility capacity, which you can afford to handle. Those who invest solely based on a perceived risk tolerance tend not to understand the math behind a drawdown's impact on achieving goals, resulting in a heightened emotional response to market gyrations.

Conversely, those who incorporate their capacity for volatility into their portfolio construction are considerably less prone to investment strategies vulnerable to an equity market drawdown that will derail their plans. Put differently, these investors can see a positive forest through the trees of negativity.

[1] https://faculty.haas.berkeley.edu/odean/papers%20current%20versions/individual_investor_performance_final.pdf
[2] https://www.fidelity.com/viewpoints/investing-ideas/the-market-cycle-and-investors
[3] Individual Investors' Learning Behavior and Its Impact on Their Herd Bias: An Integrated Analysis in the Context of Stock Trading

Negativity Hurts Growth Potential

A bias toward negative commentary, while alluring, can lead to excessively cautious or pessimistic[4] financial decisions because we assign more weight to the impact of negative events over positive ones – after all, the sting that comes with a loss tends to weigh on us more than the euphoria that comes with a win.

This phenomenon is called Loss Aversion, and it is a deeply ingrained human trait that is hard to fight. Of course, optimism in investing is not about ignoring risks but acknowledging the potential for growth and recovery despite the inevitable downturns. It's crucial to recognize that long-term U.S. equity market trends have historically been positive despite periodic bouts[5] of volatility, with equities demonstrating growth over decades.

Maintaining a negative outlook can create an environment of persistent paralysis or elongated periods of risk aversion, ultimately hindering your ability to attain your goals.[6] A positive outlook empowers investors to endure market cycles, benefiting from compound interest and growth.

While caution and diligence are valuable attributes, maintaining an overarching positive outlook is essential for successfully navigating the world of investing. In the long run, it almost always pays to be positive.

Important Disclosures

[4] Daniel Kahneman and Amos Tversky - "Prospect Theory: An Analysis of Decision under Risk"
[5] S&P 500 returns
[6] Hersh Shefrin and Meir Statman, "The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence," published in the Journal of Finance in 1985. This study delves into behavioral finance, particularly the disposition effect, which aligns with the concept of loss aversion and risk aversion in investment behavior, showing how a negative outlook can lead to decision-making that impairs financial performance and goal achievement.