Activity Bias

"There is nothing so terrible as activity without insight." – Johann Wolfgang von Goethe

In our previous article, we addressed the negative impact that overconfidence can have on portfolio returns. In this article, the third in our series on behavioral finance, we will highlight a related concept known as activity bias. Activity bias is the natural human tendency to favor activity over inactivity, especially in times of stress.

We are all familiar with activity bias in our everyday lives. When the world around us is not acting the way we want it to, we have a tendency to want to do something about it. If we see smoke coming from the kitchen, we immediately decide to do *something* about it, before identifying what that something should be. More often than not, embracing the activity bias has positive results such as preventing a house fire. Activity is associated with success, vitality, and happiness, and a lack of activity can often imply laziness or indifference. However, activity bias can also lead to actions that are detrimental or just plain silly. For example, every time you go to the airport, there is always one fellow traveler who will do whatever is necessary to be the first to board the airplane, as if such activity will get him to Baltimore faster. Although activity bias may be a benign waste of energy at the airport, in an investment context it can be downright harmful.

Getting in and out

Investment-related activity bias causes many investors to trade in and out of the market. It has often been observed that amateur investors, driven by emotion, tend to buy after periods of relative strength in the markets and to sell after periods of relative weakness. This type of activity, which is the polar opposite of the age-old "buy low, sell high" adage, has a dramatic negative impact on returns. In their 2012 study of investor behavior[1], the independent research firm Dalbar found that the average investor in U.S. equity mutual funds dramatically underperformed a simple buy-and-hold strategy over the prior twenty years. Over that time period, the average equity investor earned 99% while the U.S. stock market (as measured by the S&P 500 index) earned 350%. Although the high cost of some of the mutual funds was certainly a contributing factor, the difference in returns between the market and the mutual fund investors was mostly attributed to excessive activity. Their impatience cost these individual investors over half of their potential wealth.

Professionals make the same mistake

Professional investors, as a group, tend to suffer the adverse consequences of activity bias as well. Where

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amateur investors tend to move in and out of the market as a whole, professional investors tend to trade within the market, swapping one stock for another in an attempt to gain an edge. Unfortunately for these professionals (but even more so for their clients), trading activity is costly and usually detrimental to returns. A recent study[2] in the *Financial Analysts Journal* found that mutual funds whose turnover and trading costs were in the lowest quintile had returns that were 1.78% per year higher than the returns of the firms with the highest trading costs. Clearly, the tendency to activity is not helping the professionals either.

Activity without insight

Amateur and professional investors alike have an innate tendency towards action, despite the fact that it is usually detrimental to returns. Professional investors often have the additional temptation to use trading activity to create a sense of "sizzle" for their clients or simply to justify their existence. Instead of using activity as a way to justify his fee, a good professional advisor should have the integrity to communicate to his clients that a lack of activity does not imply a lack of thoughtful and insightful analysis. More often than not, activity leads to lower returns and the best recommendation is to stay put if a sound strategy is already in place. Making a commitment to remain disciplined is a far better strategy than succumbing to the all-too-human temptation to act just for the sake of acting, and a good advisor will recognize this and design his portfolio strategy accordingly.

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The original version of this article was written by Heritage for the July 2013 edition of The Light, a local magazine serving Broward County, Florida.

[1]Dalbar, Inc., "2012 Quantitative Analysis of Investor Behavior," (www.dalbar.com).

[2]Edelen, Evans and Gregory, "Shedding Light on 'Invisible' Costs: Trading Costs and Mutual Fund Performance", *Financial Analysts Journal*, Vol. 69, No. 1

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