RIVERFRONT INVESTMENT GROUP
Weekly View

by REBECCA FELTON

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SUMMARY

- Process, not emotions, guide our investment decisions.
- We view our risk management through both a 'proactive' and 'reactive' lens.
- The S&P 500's ability to eclipse 4,200 recently has triggered reinvestment into stocks across our portfolios.

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Some Lessons Bear Repeating: Headlines Could Use a Warning Label!

Risk Management Can Save Us from Emotional Decision Making

It has been almost three years since we wrote our first piece about the dangers of allowing headlines to influence decision making. Chances are, most of us do not remember the top stories from that year because of the 24/7 news cycle which continually scrolls across screens. An engaging headline often has an emotion-producing word or phrase that gets the reader's attention and sets the tone for the article. There are studies showing what words are most likely to trigger our emotions, thereby increasing the chances that we will click through and read more content. The more sensational the headline, the more likely we are to have an emotional response. While it is human nature for us to react, our decision-making abilities can suffer from those reactions.

"The investor's chief problem—and his worst enemy—is likely to be himself. In the end, how your investments behave is much less important than how you behave." – Benjamin Graham

This quote from one of the forefathers of investment strategy is telling because it's our behaviors that often lead us to make poor investment choices that result in bad outcomes. Behavioral finance is a field of study focused on the psychological influences on investors and financial markets -in other words, it is the study of how emotions impact investing. The emphasis on this work has grown over the past 30 years, and its significance has been underscored by the award for the Nobel Prize going to multiple economists for their efforts. Researchers have found that we all tend to have biases that reflect our emotions and can impact our decision making. Some of the most common include:

- **Overconfidence Bias**: the tendency to think we know more than we do.
- **Hindsight Bias**: the tendency to think we knew all along what was going to happen.
- **Confirmation Bias**: the tendency to seek out information that fits with existing beliefs in a self-reinforcing loop.

- **Herd Instinct**: the tendency to adopt opinions and follow the behaviors of the majority to feel safer and avoid conflict.

RiverFront's desire to break the cycle of emotional decision making led us to our motto of 'Process Over Prediction', an inherently humble investment philosophy that emphasizes repeatable processes. This philosophy has informed the creation of our tactical asset allocation and risk management processes, a hallmark of our investment process since our founding. Our tactical and risk processes guide us when we need to change directions in portfolios, whether buying a security in an asset class that we do not have enough exposure to or addressing a position that does not perform in accordance with our original expectations. The process serves as a road map and removes the temptation to react and make portfolio decisions in the heat of an emotionally charged moment brought on by seemingly urgent headlines.

We believe our Risk Management process is best categorized into two distinct components:

1. **Proactive parameters guide us in constructing and adjusting our portfolios:** We often write about the three rules that guide our tactical, or proactive, decision making: *Don't Fight the Fed*, *Don't Fight the Trend*, and *Beware of the Crowd at Extremes*. These rules, combined with other technical and fundamental indicators, help form our views of the markets and the resultant portfolio allocations when we look out over the next three to six months. For much of the summer, the three rules have been flashing caution due to the more restrictive policies in place at the US Federal Reserve and the negative technical picture illustrated by the trend of the 200-day moving average of the S&P 500 Index. Testament to the unemotional nature of our tactical rules is the fact that they often turn cautious when optimism is high, and markets are moving higher. Alternately, they can signal it is time to add risk before it feels comfortable to turn more bullish.

2. **Reactive risk tools help us 'course-correct' when an allocation or position does not perform in -line with expectations***:* Any time a portfolio decision is not working, it can cause disappointment, anger, or a host of other emotions. Because we believe that admitting mistakes is crucial to growth and future success, our reactive process forces us to go through specific steps to mitigate these types of portfolio risks. One of those is to establish what a bad outcome would look like before we purchase any new position. Another step is to conduct a 're-underwriting' process designed to re-evaluate both the bull case and the bear case for the position to determine appropriate next steps. The reactive risk lens is applied to those portfolio positions which create significant variances relative to our benchmarks.

Bottom Line: We believe that prudent investment decisions are those made when investors can tune out the noise of the current headlines and remain focused on their own long-term plans, goals, and objectives. While having a risk management process does not always prevent us from negative returns, it does remove the temptation to react to the daily barrage of headlines and provides a framework to unemotionally navigate through volatile periods in the markets.

One real-life example of our risk management discipline in action is our most recent portfolio trades. While our fundamental view and quantitative technical models remain cautious on the market, the material breach above 4,200 on the S&P 500 represents a decisive technical breakout, in our opinion. Markets have now retraced around 50% of the entire market selloff from January of this year, which we view as a positive signal that this current rally may be more than simply a short-lived bear market bounce. While the market action has been contra to our investment thesis, we continue to focus on 'process over prediction'; hence we feel now is the time to move the portfolios closer to portfolio benchmarks by adding stocks.

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Standard & Poor's (S&P) 500 Index TR USD (Large Cap) measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

In a rising interest rate environment, the value of fixed-income securities generally declines.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero).

Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Don't Fight the Fed – 'Supportive' means the Fed's monetary policy regarding inflation and employment is in what we believe based on our analysis to be the investors' best interest; 'Against' means the Fed's monetary policy, in our view, is going against the investors' best interest; 'Neutral' means the Fed's monetary policy is neither supportive or against the investors' best interest in our view. Don't Fight the Trend – Terms correlate to the 200-day moving average as it relates to the equity indexes: 'Positive' means that the trend is rising, 'Flat' means the trend is flat, 'Negative' means the trend is falling. Beware the Crowd at Extremes – Terms correlate to the NDR Crowd Sentiment Poll and its measurement of Extreme Optimism (Bearish), Neutral, or Extreme Pessimism (Bullish).

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