

# Quality Asset Management

*Grow Your Wealth with Peace of Mind*

## Are you Optimistic or Pessimistic?

*By Gil Hanoach, June 1, 2008*

Do you believe that your diversified stock portfolio will go up or down in the next 12 months? If you answered “down” – you are not alone. Most people are pessimistic after declines. This article presents two main reasons for this belief and a flaw with both reasons.

**Reason #1: It went down recently, and is likely to keep going down.** We tend to remember recent events better than older events, and give them greater importance. This is a psychological effect called “Recency”. In the context of investing, we tend to believe that declining stock investments will keep declining. Since stock markets go up in the long run, with fluctuations around their long-term growth, it is impossible that declining markets will keep declining forever.

Even when people understand this contradiction, they think that their stock portfolio will go up, just not anytime soon. They plan to keep money outside the stock market until it starts going up, but fail to find the turning point. One reason is that stock prices fluctuate within long-term trends. By the time they realize that the recent increases are the beginning of a long-term recovery, they miss out on enough of the gains that they underperform a buy-and-hold approach.

**Reason #2: The economy has slowed down and is believed to keep slowing further.** This belief is actually irrelevant (whether flawed or not) to the prediction of stock performance. Stock prices reflect the belief about their future value. They decline because there is a majority belief that the economy will slow down in the future. The behavior of the stock market in 12 months reflects the expectation regarding the economy many months later, which is much harder to predict than the near-term future of the economy.

**One consistent truth:** Since people that try to predict the near-term future tend to underperform their own portfolio, the best thing you can do is focus on a more predictable pattern: the long-term. In the long run, stock markets tend to go up. This was true in the past since people depended on companies to produce their goods, and should keep holding true as long as people will keep depending on companies for their daily consumption of goods and services. Human preference for getting things easily and cheaply is likely to keep the concept of companies going, and as a result: stock prices growing.

**Solution:** Your best strategy is to be optimistic about your investments at all times. Given the substantial long-term growth of stock markets, you can be even more optimistic during decline periods. There is no guarantee for a quick recovery after declines, but the longer and/or deeper the decline goes the steeper the recovery is likely to be.

### Summary

Psychological biases and misconceptions drive us to be pessimistic about the future of our portfolio right when we have more reasons to be optimistic. Worse, it leads some people to gamble with their own money, trying to time the market. Staying consistent with the stock portion of your investments is not only the smartest plan; it is also the most conservative.

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