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Rosefinch Research | 2022 Series # 20

Investment Pitfalls of "Terminal Paralysis" and "Loss Cycle"

In the last two months, Chinese equity market's rebound speed and extend have exceeded most expectations. From the April 26th low to July 5th, the Chi-Next rose +30%, SSE rose +16%. Amongst the 31 Shenwan industries, 27 of them rebounded over +10%, 10 of them +20%, and some new energy related industries were +50%. So did you catch the rebound? According to the # of shares in equity mutual funds, many investors missed the rally. **If we are to use an analogy to describe the situation: it's like the investor is chasing an accelerating car – you worry that if you don't jump on, it'll go faster and get away; at the same time, you worry that if you do jump on, it'll suddenly stop or flip over.** This dilemma is quite often during V-shape market recoveries. Investors usually cut loss and exit markets during periods of sharp drop, and then miss the rebound because it happened too quickly. And as the rebound gather steam beyond 20%, the same investors are afraid to chase the highs for fear of another major reversal. This mentality of fear is also named "terminal paralysis," which was coined by the GMO CIO Jeremy Grantham, the legendary investor who successfully called two major stock market crashes. Jeremy sees the "terminal paralysis" happening when people hold onto cash during market crashes and take the wait and see "paralysis" state. This means that those people sitting on a lot of cash will usually miss the tremendous gains from the market rebound.

Another market pitfall comes from the investment behavior named Loss Cycle**. In his book "The Little Book of Behavior Investing," James Montier looked at some of the behavior biases of investors, which often form the Loss Cycle.** Keynes once said people long for immediate impacts, especially when it comes to money. The modern investors are obsessed with their stocks' annual, quarterly, or even monthly valuations. As a macroeconomist, Keynes has unique insight on the investor mentality. After all, he once said: in the long-term, we're all dead.

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The first part of the Loss Cycle is the investor's desire to get-rich quick. In the short term such as one year, the investment return comes from mostly the change in its valuation multiple. In other words, it's more due to change of the market sentiment than the change in intrinsic values. In a longer term like 3 to 5 years, the total return will come mostly from the increase in the intrinsic value of the stock and how cheaply you bought it. This is the point of long-term investing where the key issue is giving your stocks the time to develop and grow. Even the best companies will need time to grow, and the most returns will come from the compounded profit growth of the company.

The second part of the Loss Cycle if the investor's desire to act. In Montier's book, he gives an example of soccer game. In a soccer game, the average number of total scores is 2.5. During the game, the chance of scoring on a penalty is 80%. So penalty taking is a crucial contributor to a game's outcome. Researched analyzed 311 penalty shots in the top leagues across the globe, and found that the penalties taken split roughly equally into three directions of left, center, and right. Yet, the goalies' actions are not evenly distributed across these areas: there is a clear bias: 94% of the time they'd leap left or right, and only stay in the middle 6% of the time. So why do they only stay in the middle 6% of the time when the ball is struck towards the center over 30% of the time? In fact, statistically, when the goalies stay in the middle, they successfully block 60% of the shots; and when they dive to the sides, they only block about 19% of the shots. They therefore have a higher success rate when they stay in the middle rather than diving to the side. The goalie's common explanation is as follows: when I leap left or right, at least I'm doing something about it. But if I stay in the center and watch the ball is struck left or right, I'd feel awful! The investor's behavior is the same: when the market is dropping, I do something about it by cutting my positions; when the market is rallying, I do something about it by building my positions. In fact, when you do nothing, your chance of success will be higher. The key to success is therefore not the winning percentage of long-term holdings, but how to overcome the desire to act.

When the market drops, investor's action will probably lead to a loss, and suffering losses can reinforce the "act"-bias. The investor may feel even stronger urges to act, which turn into a disastrous high-frequency-heavy-loss scenario. **The third and most damaging part of the Loss Cycle is therefore this reinforced action bias.** Once the investor gets into this Loss Cycle, the investor can't help but trade frequently into a negative cycle. The entire cycle will go through over and over again, as the investor wants to get rich quickly, then follow it by action, and finally gets sucked into the vortex of high-frequency action and piling up losses.

We've looked at the two common investment pitfalls of "terminal paralysis" and "loss cycle." Now that we're aware of them, the question becomes: how do we climb out of such pitfalls? For example, how do you overcome the desire to get rich quickly? This desire is part of human nature - even Buffett has acknowledged that very few people are willing to get rich slowly. When the whole market is advertising success stories of double, triple, or ten-bagger stocks, they're reminding you that you too can get rich quickly. Another example of such pitfall behavior is to overcome desire to buy high and sell low. Investors are glued to daily price fluctuation; many even check mutual fund prices multiple times a day.

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For them, the increase in valuation is not just a number, but a gateway towards a better children education, a future family holiday, a great home improvement idea… but as the market tanks and these dream bubbles burst one by one, how does the investor control the urge to redeem and protect what's left? It might be easy for investment professionals talk about overcoming the buy-high-sell-low urges, it's very hard for normal investors to do it sustainably with their willpower alone. **Willpower is a limited and precious resource, which can easily be depleted over a day's numerous distractions.** It's difficult, if not impossible, to count on willpower alone to hold back the daily urges to act.

The solution to this lies not in telling investors to overcome their emotional human tendencies, but to teach them effective and sustainable ways of how: create reasonable expectations and investment discipline. To create a reasonable expectation, you can anchor a reasonable long-term return target. Buffett, who is the gurus of long-term investing, has achieved an annual return rate of 20%. For a normal investor, achieving half that or 10% is already very good. Once you set your target at 10%, you can become less swayed by the headline returns of 40%, 60% or even 400%. This is the anchor effect: by focusing on one thing, you reduce the distraction from other things.

To avoid chasing the market, it's important to establish investment discipline, such as monthly averaging purchasing plan. Of course, if you avoid the trading days with biggest drawdowns, you can improve your total return dramatically. But how do you know which days will be the biggest drawdowns? And even if you miss those days, how do you get out of the "terminal paralysis"? So if you, like most investors, can not sidestep the worst day and then presciently, then it's best to stick with your averaging purchasing plan.

Famous economist Paul Samuelson and the first American to win the Nobel prize in Economics once said: "Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas." **Waiting is actually the norm for investing.**