It's understandable why these superstitions are so common. We want to be able to predict future market movements and protect our hard-earned savings from wild market swings. (UBS)

Don't let behavioral bias eclipse your investment strategy

08 April 2024, 2:56 pm CEST, written by UBS Editorial Team

Monday, 8 April, marks a total solar eclipse for many parts of the mainland US. This will be the only total solar eclipse in the 21st century where totality will be visible in Mexico, Canada, and the US, and the last total solar eclipse for the US until August 2044. Millions of onlookers across the country will stand fully in the shadow of the moon, which will block out the sun's light, creating a 360-degree sunset and an artificial "night." For about two minutes, brighter stars and planets will be visible as if it were nighttime.

Many cultures around the world view solar eclipses as something unnatural. Due to a logical fallacy known as *post hoc, ergo propter hoc* (meaning "after this, therefore because of this"), natural disasters, famines, and wars were often blamed on solar eclipses that had occurred beforehand. For example, an 1133 solar eclipse was retroactively named "King Henry's Eclipse" when King Henry I of England died two years later in 1135. Over time, these types of coincidences formed the basis of superstitions, and eclipses became a source of fear.

Where do superstitions come from?

Superstitions are a form of cognitive bias. They are a way for us (as a species) to assign order to outcomes that otherwise don't make much sense, helping us to cope with anxiety and uncertainty.

One reason that superstitions are so common is that our brains are amazing pattern-recognition machines. In fact, we are so good at identifying patterns that we can find them even in random noise. For example, we can identify patterns in a random series of numbers such as the digits of pi, or find shapes that look like human faces in the mountains of Mars or the char marks on a piece of toast.

When it comes to investing – where there is lots of noise and random data to be found – superstitions have become quite common. For example, you may have heard of patterns such "sell in May and go away," "the January effect," and "the Santa Claus rally." There are also several patterns based on the presidential market cycle—or even the solar cycle—that try to predict when the next market downturn will occur.

It's understandable why these superstitions are so common, and why the allure of superstitions is so difficult to resist. We want to be able to predict future market movements and protect our hard-earned savings from wild market swings. It's hard for us to accept that short-term market movements are unpredictable, especially when our brains are constantly telling us to look for a pattern and a story that makes sense of all of the chaos.

Unfortunately, history tells us that most patterns in random data are illusory, and that there are no market timing strategies that are reliably better than a buy-and-hold approach. Headlines like "the last time this happened, the market fell 20%" are often nothing more than modern-day superstitions. They give us a comfortable, but false, sense of control over the future.

How can we overcome the temptation to time markets?

Over time, our understanding of solar eclipses has improved dramatically. Scientists can now predict the timing of eclipses centuries in advance, so we no longer look for other ways to explain the phenomena.

Unlike the hard science of astronomy, short-term markets are driven by human psychology, so we will never know when the next 10% market correction will occur and we'll never be able to fully sate our pattern-recognition urges. Even so, there are investment strategies that can provide us with more control and certainty over outcomes. For example:

1. **Ignore short-term returns.** In our everyday life, we have more certainty in the short term than the long term. Change takes time, and tomorrow is likely to look a lot like today. By contrast, financial market returns are virtually random in the short-term, and much more predictable over the long term. Since 1926, the stock market's daily returns have been a coin toss (56% chance of a gain, 46% chance of a loss). By contrast, 1-year returns have mostly been positive (around an 80% chance of a gain and a 20% chance of a loss). Only about 6% of 10-year returns have resulted in a stock market loss. We recommend that you avoid decision-making over short-term periods, where randomness dominates outcomes. Instead, you should make decisive investment decisions when you can afford to invest for years and decades—time horizons where financial market returns more closely resemble the slow but steady march of progress.
2. **Manage risk based on time horizon.** Because of the uncertainty and volatility of short-term returns, investors should aim to segment their investments based on time horizon and purpose. We can't predict when the next market decline will occur, but we do know that historically diversified portfolios have fully recovered—even from the worst bear market declines—generally within 3-5 years. Therefore, we should be conservative when investing any assets that are earmarked for such short-term goals, but be comfortable taking more risk with assets that can remain invested for longer time horizons. This also implies that your investment strategy should reflect your goals. When you are young and your spending goals are far in the future, your portfolio should be invested for growth—if there are market declines, it will be an opportunity for you to put your hard-earned savings to work at a lower price! When you are retired, you will need to set aside more funds in a safe investment strategy, but you will still be able to invest for growth with the funds that are earmarked for later in retirement, or for your philanthropic and inheritance goals.
3. **Focus on your goals.** We do not have control over financial markets, or even the ability to predict short-term returns reliably. Fortunately, market returns are only one variable in the formula of financial success. There are many other aspects of investing where we should focus our attention on managing risk and embracing opportunities to enhance after-tax wealth potential. For example, we can use a Savings waterfall to make sure we're getting the most out of our hard-earned savings. We can review our insurance needs to make sure that our families are protected in case something happens to us. And we can work with our financial advisors and tax advisors to make sure that we're managing our income tax burden in retirement.

To learn more about behavioral biases and how we can reduce their impact on our portfolio returns, ask your advisor for a copy of *Bias-free investing: Managing stress in uncertain times*. To learn more about financial planning opportunities that can help you control non-market risks to your financial success, check out our Retirement Guidebook at www.ubs.com/retirementguidebook.

Main contributor: Justin Waring

Important information

As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.

© UBS 2023. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.

There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.