From an entirely rational perspective, the last few weeks of volatile market declines have created a strong opportunity for investors. The average stock in the S&P 500 is 13 percent cheaper than it was on April 23, 2010 — a fine bargain considering nothing much has changed about the sales and earnings prospects of these companies, which continue to crush analyst expectations. Still, as of May 21, 2010, 64 percent of S&P 500 companies were oversold — a percentage not seen since March 11, 2009.\footnote{Weeden & Company} Unfortunately, fear has and will continue to precipitate selling, when it should do the opposite. Certainly fears over Greece are understandable, but to put it in perspective, Greece accounts for a similar percentage of theEMU’s GDP as the city of Atlanta does for the United States.

One fascinating study sheds light on people’s behavior in markets like this one and highlights why now is the time to buy, not sell, equities. In the study, originally reported in a Wall Street Journal article entitled “Lessons from the Brain-Damaged Investor” and led by researcher Baba Shiv of Stanford University, a group of 41 participants played an investment game where each was given $20 to start and asked to make 20 rounds of one dollar investment decisions based on a coin toss. They would choose either “invest” or “don’t invest.” If they chose “don’t invest,” they kept their dollar. If they chose “invest,” the researcher took the one dollar and flipped a coin. If it came up heads, the dollar was lost but if it came up tails, the investor was rewarded with $2.50. Clearly the most profitable strategy would be to play every round, as the expected value of each one dollar “invested” is $1.25. The twist in the study was that one group of participants had suffered brain damage which affected key emotional centers in the brain such as the orbitofrontal cortex, the amygdala, or the insula. The other participants had either no brain damage at all or brain damage that affected non-emotional centers of the brain. Those without any emotional brain damage invested just 58 percent of the time ending with $22.80 on average. Those participants with brain damage outperformed their healthy counterparts by 14.5 percent investing 84 percent of the time and ending with an average of $25.70. The main reason participants with normal brains did so poorly was because of their behavior after a loss. Instead of recognizing the very simple positive expected value of choosing “invest”, the normal group was scared of losing twice in a row and as a result invested just 41% of the time after a loss. The damaged group maintained their overall percentage after a loss, investing 85% of the time. This study illustrates that fear, loss, and risk avoidance act as a tax on our portfolios if we do not take action to circumvent their influence.

Real life investors have even better odds of winning than the participants in the study. A coin toss is 50/50, but the stock market goes up 72 percent of the time.\footnote{Based on U.S. market data since the founding of the U.S. stock exchange.} What’s more, as we have written in several previous commentaries, our research shows that following major declines, those odds are even better as markets consistently revert to the mean.

The year 2009 is a perfect example of what has been demonstrated to be the profitable strategy would be to play every round, as the expected value of each one dollar “invested” is $1.25. The twist in the study was that one group of participants had suffered brain damage which affected key emotional centers in the brain such as the orbitofrontal cortex, the amygdala, or the insula. The other participants had either no brain damage at all or brain damage that affected non-emotional centers of the brain. Those without any emotional brain damage invested just 58 percent of the time ending with $22.80 on average. Those participants with brain damage outperformed their healthy counterparts by 14.5 percent investing 84 percent of the time and ending with an average of $25.70. The main reason participants with normal brains did so poorly was because of their behavior after a loss. Instead of recognizing the very simple positive expected value of choosing “invest”, the normal group was scared of losing twice in a row and as a result invested just 41% of the time after a loss. The damaged group maintained their overall percentage after a loss, investing 85% of the time. This study illustrates that fear, loss, and risk avoidance act as a tax on our portfolios if we do not take action to circumvent their influence.

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The year 2009 is a perfect example of the price investors pay for shunning the stock market after a loss. During 2009, the S&P 500 was up 26.4 percent while the Barclay’s Aggregate returned just 5.9 percent. During this same time, total flows for equity funds were negative $8.6 billion while total flows into bond funds were a staggering $375 billion. Not only were equity flows negative, the vast majority of the selling came at the worst possible time: February and March near the market bottom. Investors acted just as Professor Shiv’s participants did after a loss, avoiding what has been demonstrated to be the better investment decision entirely because of fear.

Now is precisely the time that we need to be aware of these tendencies in ourselves and to take action to squash them. We encourage all of our clients to stay calm and, if possible, add money to the market. The yield on the O’Shaughnessy Enhanced Dividend portfolio is 5.8 percent,\footnote{As of 5/21/10; Yield is subject to significant change and is not a guarantee.} up from 5.1 percent just three weeks ago. Stocks in our Small to Mid Cap Growth portfolio are 20 percent cheaper on average than they were three weeks ago. If we offered those sorts of deals to prospective investors on April 23rd they would have been thrilled, but one of fear’s largest side affects is market paralysis, a reluctance to take advantage of clear opportunities. We encourage everyone to overcome this paralysis and take action.

\footnotetext[1]{Weeden & Company}
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OSAM may from time to time manage an account by using non-quantitative, subjective investment management methodologies in conjunction with the application of factors.

The hypothetical backtested performance results assume full investment, whereas an account managed by OSAM may have a positive cash position upon rebalance. Had the hypothetical backtested performance results included a positive cash position, the results would have been different and generally would have been lower.

The hypothetical backtested performance results for each factor do not reflect any transaction costs of buying and selling securities, investment management fees (including without limitation management fees and performance fees), custody and other costs, or taxes – all of which would be incurred by an investor in any account managed by OSAM. If such costs and fees were reflected, the hypothetical backtested performance results would be lower.

The hypothetical performance does not reflect the reinvestment of dividends and distributions therefrom, interest, capital gains and withholding taxes.

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Simulated returns may be dependent on the market and economic conditions that existed during the period. Future market or economic conditions can adversely affect the returns.