Can you take it?

The truth will set you free

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Logical investors know that adopting a sound investment strategy will increase returns and decrease volatility (i.e., risk). They know this is accomplished by adding various types of assets from around the globe, but only by adding those which are most likely to help accomplish this mission.

Logical investors also know that markets become expensive or underpriced at times, but they have confidence in their strategy since they fully understand it. This confidence allows them to stick with it when times are most dangerous: when markets are either over or undervalued by the crowd.

Enter a phenomenon especially prevalent in the United States: Frame-of-reference risk.

Even though the logical investor knows that diversification around the globe has consistently been shown to maximize return for any level of risk, investors in the United States often cannot bear when their returns do not match those of the Dow & S&P500. This may be hard for many to currently understand since both the Dow & S&P500 have remained virtually flat for the past decade while other investments have provided stellar returns, but bear with me.

Americans are constantly bombarded with news of Dow & S&P500 performance, thus we tend to gauge our own performance by those standards. This causes most investors to feel more pain when their well diversified portfolios underperform these benchmarks than delight when these same portfolios outperform.

If we were logical investors this would not be the case, but for most of us it is. You should recognize this seemingly illogical response and realize you may harbor some of it yourself. The following is a good test of your resolve:

How do you feel about these results? Most people I show this to are indifferent.

Investment	Returns
A	15%
B	-20%
C	18%
D	35%
Total Weighted Return:	12%

Let's try this exercise once again. How do you feel about the results?

Investment	Returns
Foreign Emerging	15%
Foreign Developed	-20%
Real Estate	18%
United States	35%
Total Weighted Return:	12%

Logic would tell us we should feel indifferent between the two scenarios, but when the blind is removed most of us are repulsed. Our frame-of-reference simply causes most of us to react negatively when we realize we could have earned more domestically. This no surprise as daily bombardment of Dow and S&P500 performance data simply creates an anchor by which we measure our own results.

The truly logical investor knows that at the end of this period he should *sell* some of his U.S. holdings and purchase more of the other asset classes. This investor knows the allocation above has a much better chance of delivering superior results in the long run, but that is not what is most important. Of greatest importance is knowing yourself. If frame-of-reference risk would cause you to abandon a strategy, you should adjust that strategy using knowledge about what you will likely actually *do*.

Due to frame-of-reference risk, rare is the U.S. investor that can hold fast as U.S. investments outperform. For two decades leading up to the 1990s, foreign investments had spectacular performance. Most investors who had adopted a disciplined approach had no trouble selling a bit of their foreign holdings to purchase underperforming ones in the United States. Then the tables turned.

During the 1990s, U.S. investment provided spectacular returns, with the most extreme example occurring in 1998 when U.S. stocks returned 28.5% while Non-U.S. stocks *lost* -17.5%!! The logical investor would have simply sold some of his U.S. holdings to purchase foreign ones, but as individuals we are not without emotion.

During the 1990s, most investors simply abandoned their investment strategy altogether in favor of U.S. stocks. Then came the 2000s when U.S. stocks performed miserably compared to foreign ones. The abandonment of investment strategy couldn't have happened at a worse time!!

The point of this exercise is to show that frame-of-reference is *real*. Even though logic would tell us there is a more optimal long-term strategy, a strategy that will be abandoned when it is needed most is ***not*** a good strategy.

You need to be aware of yourself and develop a strategy you know you will be able to stick with through thick and thin. This may mean adopting one we know is a less than optimal, but most critical is adopting one you won't abandon.