Date Issued: 2020

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Managing Experience vs. Expectations

Tuttle Tactical Management

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Introduction

When it comes to investing, we are often encouraged to take a long-term approach, which is important. However, preparing for the long term has typically centered around education and market information but often ignores a vital component: managing our emotions and experience vs. focusing solely on our expectations (which often attempts to avoid uncomfortable or negative emotions in lieu of learning to manage them).

The Problem

Traditionally, the financial industry has encouraged advisors to help their clients take a long-term approach by managing expectations through information (e.g., projections, track records) and in using discipline in the attempt to avoid potentially uncomfortable emotions.

The Problem (cont.)

With traditional money management approaches, clients tend to experience large losses, partly because they may be getting in or out of the market at the wrong time, but mostly because the financial industry preaches discipline in staying invested (and avoiding emotion) during the inevitable bear markets. In other words, the industry often asks us to ignore our emotions for the sake of staying invested. However, when people inevitably become overwhelmed by the same emotions they've been asked to suppress, they will be more likely to make bad decisions. This is why managing expectations generally doesn't have a positive outcome. It can be very difficult to maintain a long-term view given the factors affecting clients' emotional realities as market conditions change: fear, greed, time dilation, and projecting. Though education can help serve us, it is through our ability to manage our *experience* that helps guide us down a better path.

Managing Experience

When it comes to investing, we are often told that we should be disciplined, or in other words, ignore our emotions, but this does not obviously take into account emotional reality. Managing one's experience is different from managing one's expectations. When we manage one's experience, we are helping to **manage emotions through leadership,** not just education. Managing experience can help smooth what is sometimes a difficult emotional journey through ever-changing market conditions.

By managing our experience and emotions, we can develop the capacity to experience fear, greed, and time dilation without becoming overwhelmed.

1. **Fear:** We can manage downside protection so that emotions are less likely to drive investment decisions.
2. **Greed:** Along with fear, greed often impacts our decisions. But we can reduce the influence of greed through the knowledge that we can seek an upside so you can stay the course while also seeking gains without the disappointment of large losses.
3. **Time Dilation:** Time dilation is part of the human condition in that people may tend to feel that the immediate past or present will continue into the future. There may be a tendency to think that the way things are, good or bad, will remain the same. This tends to give people a distorted image of the future. This can result in entering and exiting markets at the wrong time. We can deal with time dilation by acknowledging that drawdowns happen while also helping to ensure they are shallow and do not last long.
4. **Projecting:** We sometimes feel that the market will reflect our lives and what we've been through emotionally.

If the above factors are not mitigated properly, investors can find themselves getting in and/or out of the market at the wrong time, potentially setting up for unexpected and unnecessary losses.

Managing Risk vs. Managing Emotions

	Managing Expectations	Managing Experience
Overview:	Avoiding and denying emotions and feelings.	Accepting and acknowledging emotions and reality.
Greed:	Get invested so you do not miss the rally.	Portfolios adaptively adjust.
Fear:	Sell so you don't lose more money.	Emotionally support yourself.
Time Dilation:	The market will continue, good or bad, based on how it's currently been performing.	Acknowledge and commit to being able to make tough decisions and manage tough emotions.

Understanding how managing one's experience through our own confidence and leadership can be more effective than managing one's expectations via track records and value offers can also help us aim for return streams designed with human emotions in mind vs. arbitrarily trying to capture the best return with little regard to the emotional journey of the investor.

Being Responsive vs. Reactive

Another important factor in managing one's experience involves helping clients develop a responsive mindset, as opposed to a reactive one. Being responsive refers to the ability to respond in real time and in a calculated and deliberate way. Conversely, being reactive refers to taking immediate actions based solely on emotions.

Whereas a reactive mindset can be based on underlying fear or greed and can cloud one's judgment in making investment decisions, a responsive mindset attempts to manage one's emotions by applying sound judgment and science, in real time, as markets change. This, coupled with developing emotional resilience, can help one respond effectively to ever-changing markets.

This is sometimes considered an underlying idea behind tactical investing, when it's done properly. Proper tactical investing does not rely on timing or predicting the future, but rather on one's response, in real time, to new market directions, which can help smoothen a client's emotional journey.

Chasing Talent, Not Performance

When we stop solely looking at performance and begin considering who can best guide one's portfolio based on one's overall goals, we can gain a more comprehensive approach, one that utilizes forward-looking due diligence. This process starts with standard measurement systems, such as track record, correlation, and volatility. Then it looks at every manager in the program against four filters:

1. **Return Attribution.** From a reverse-engineering standpoint, where have any recent returns come from?

2. **Attribution Persistency.** Will the current performance persist going forward, and, if so, why?

3. **Tail Risk Analysis.** What factors may contribute to potential loss?

4. **Portfolio Flexibility.** What changes in strategy, if any, would managers be willing to make?

Benchmarking

One of the primary reasons someone invests is to have more money in the future than they have today and to meet some goal, be it retirement, paying for college, etc. To help gauge the extent to which their investments are performing, individuals may rely on certain benchmarks, such as indexes. However, this can be a potentially dangerous practice, partly because they focus our attention on the wrong thing.

In general, benchmarks were designed for institutional investors who may have infinite time frames and resources to be able to judge how their money managers are doing. In contrast, most individual investors do not have unlimited time frames or resources; for them, the only real benchmark should be how they are doing in comparison to their goals. For example, if a couple needs two million dollars to retire at age 65, are they on track or not? If they focus too much on a benchmark, these investors may lose sight of their actual goal and instead focus on a measure that may have no direct relation to the reason they entered the market.

Take, for instance, the period between 2000 and 2010, during which time the S&P 500 produced little-to-no average annual returns for many investors. If an investor was only focused on beating that benchmark, then a $1 increase in net worth could be labeled a success. However, for the average individual, losing 10 years of significant appreciation could be detrimental to meeting their goals.

Being focused on benchmarks rather than on overall goals can also cause individuals to take too much risk or too little risk. For example, if one's portfolio is performing above a benchmark, they may develop a sense of accomplishment that limits additional potential growth that could come with taking on more calculated risk. Likewise, if their portfolio is performing below a benchmark, they may feel as though it is failing and may be prone to either pull out of the market to stem losses or take on too much risk in the attempt to “catch up” to the performance of a benchmark.

Benchmarking (cont.)

The same goes for market fluctuations. When the market is going up, people want to be in it. Likewise, when they hear the market is going down, they want to be out of it. One of the unfortunate reasons why individual investors typically do much worse than the markets is because they buy and sell at the wrong time, partly because they may be focused on indexes and not on their goals.

The Changing Market

Learning to manage one's emotions as the market changes is important to potential long-term success. The dynamics that drive the market have changed considerably from the past. Today, we have to deal with the following factors:

- ❑ continued interwoven globalization
- ❑ the rate that change occurs has accelerated in relation to past change
- ❑ markets generally now operate continuously, 24-7
- ❑ factor investing is replacing asset classes
- ❑ we are in the longest running bull market in history
- ❑ toward the end of a bull market, money tends to rotate in and out of different sectors more quickly
- ❑ presidents can now move markets in extremely unpredictable ways
- ❑ federal reserve policy is changing

Testing Your Mindset

Use the following questions to help assess your current mindset and manage your experience.

Tactical Modern Portfolio Questions

1. If I combine tactical managers, how do I deal with security overlap?
2. Why aren't you correlated with the S&P?
3. How can you possibly avoid a bear market?
4. If the market is going down, how can you possibly make money?

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Testing Your Mindset (cont.)

Tactical Market Timing Questions

1. The market is going up today. Why aren't you up?
2. The market is going down today. Why are you down?
3. The market had a correction. Why didn't you see that coming?
4. Why didn't you get out at the top?
5. Why didn't you get in at the bottom?

Advanced Tactical Questions

1. How can you avoid problems in a choppy market?
2. If you get out and the market goes back up, do you have a mechanism to catch up?
3. What premise(s) is your model based on?
4. Do you backtest your models?
5. If so, do you use walk-forward testing?
6. What risk/return metrics do you look for?
7. How do you avoid curve fitting?
8. Why will your model performance persist?
9. How often do you review your models?
10. What could go wrong?

Summary

Because of the significance that investment decisions can hold for you, your lifestyle, and your goals, it is important to recognize the role that one's emotions typically play in making these decisions. While being educated about the market is important, such education does not address the reality that unmanaged emotions can be the primary driver of our decision making.

Often, the financial industry can encourage a stoic mindset toward long-term investments. The potential danger here is that if one is not coached on how to manage one's experience, unchecked emotions could result in a reactive approach to market changes (e.g., getting in or out at the wrong time). By adopting a responsive mindset, we can attempt to mitigate factors such as fear and greed while seeking gains and managing downside protection.