

Investor Behavior and the Capital Cycle

Author



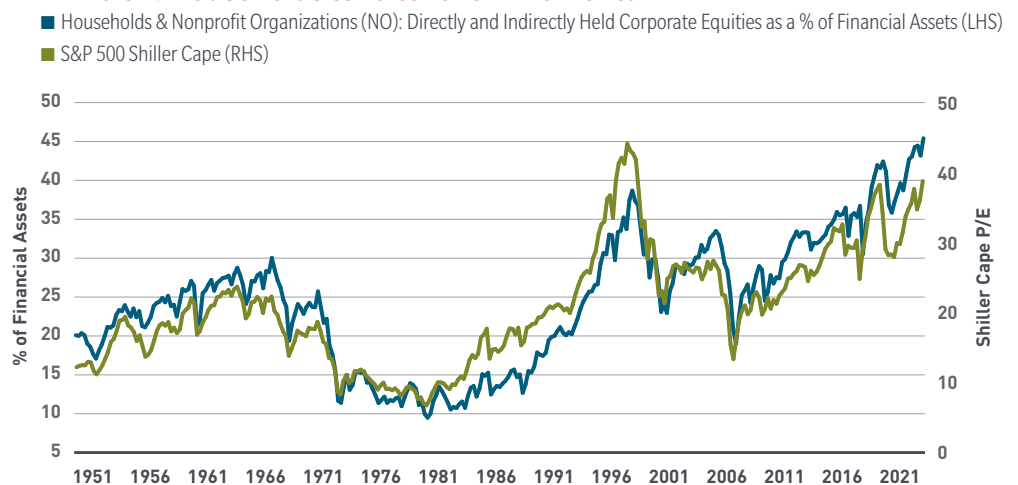
Robert M. Almeida
Portfolio Manager and
Global Investment Strategist

In brief

- Non-professional investors often exhibit “buy high, sell low” behavior, driven by biological programming that seeks pleasure (investing in high-performing assets) and avoids pain (selling underperforming assets).
- High household equity allocations suggest that future equity market returns may be disappointing.
- By employing “Time Horizon Arbitrage,” professional investors leverage training and discipline to counteract emotional, biologically driven behaviors.

There is a behavioral paradox at the heart of financial markets that, on the surface, appears counterintuitive: non-professional investors tend to buy stocks when they are expensive — when trailing returns are strong — and sell when they are inexpensive, after trailing returns have turned negative. Exhibit 1 captures this dynamic.

Exhibit 1: Households tend to follow momentum



Source: Households & Nonprofit Organizations (NO): Directly and Indirectly Held Corporate Equities as % of Financial Assets sourced from Board of Governors of the Federal Reserve System (US), retrieved from Federal Reserve Bank of St. Louis (FRED) on 14 October 2025. S&P 500 Shiller Cape sourced from FactSet, Robert Shiller, Yale University Department of Economics. US Shiller Cape ratio is the price-to-earnings ratio based on average inflation-adjusted earnings from the previous 10 years. Quarterly data from 31 December 1951 to 30 June 2025 (Households & Nonprofit Organizations (NO): Directly and Indirectly Held Corporate Equities as % of Financial Assets) and 30 September 2025 (S&P 500 Shiller Cape).

This “buy high, sell low” pattern, while seemingly illogical, makes a tremendous amount of sense when viewed through the lens of human nature and our biological programming.



The Biology of Market Cycles

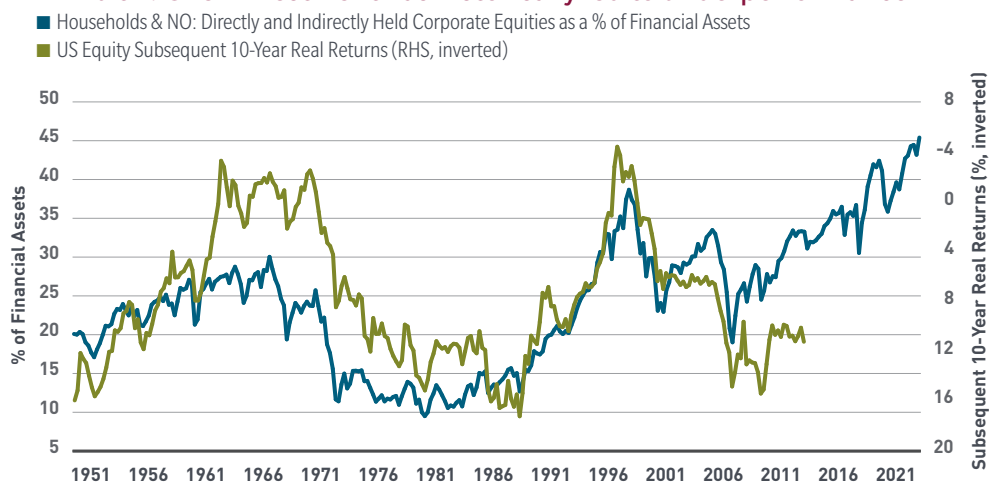
All species are genetically programmed with a reward system designed for survival and procreation. Our brains are hardwired to seek pleasure and avoid pain. For example, a ripe strawberry tastes good and elicits a positive chemical response, such as a dopamine release, which encourages us to find and eat more. Conversely, things that are harmful to us tend to disgust and repel.

This same biological programming drives the capital cycle in financial markets. When an economy, sector, industry or specific financial asset delivers outsized returns, it “tastes good,” triggering a powerful, dopamine-driven impulse to invest more capital into it. Conversely, negative returns trigger an aversion response, causing capital to flee. This creates a self-reinforcing cycle of overinvestment in high-return areas and underinvestment in low-return ones, ultimately leading to the booms and busts that define economic and market history.

If the Past is Prologue

Households' high allocation to equities (Exhibit 2), suggests that equity market returns over the next decade may be quite different from those in the past.

Exhibit 2: Over investment has historically led to underperformance



Source: Households & Nonprofit Organizations (NO): Directly and Indirectly Held Corporate Equities as % of Financial Assets sourced from Board of Governors of the Federal Reserve System (US), retrieved from Federal Reserve Bank of St. Louis (FRED) on 14 October 2025. US Equity Subsequent 10-year real returns sourced from Morningstar. US Equity represented by Ibbotson Associates Large Cap Stock (proxy for S&P 500). Real returns calculated by deflating index level by US Consumer Price Index. 10-year real returns are calculated using monthly data, but displayed quarterly. Returns are annualized, gross and in USD. Quarterly data from 31 December 1951 to 30 June 2025.

Perhaps a more appropriate way to think about future returns is through the lens of the capital cycle. When capital is under- or over-allocated versus a project's expected utility, returns get distorted. Asset price volatility occurs when new data disproves prior return assumptions.



While the recent US earnings season showcased strong profits, we think expectations were generally reflected in stock prices, given current valuation. At the same time, credit losses emerged; many consumer-facing companies cited affordability issues and weakness was seen among businesses threatened by AI, such as software businesses with seat-based licensing models. However, beyond the quarterly results, we continue to worry about stretched valuations, the sustainability of elevated profit margins in the face of higher interest rates and a resurgence in capital expenditures to defend long-held economic moats against AI-fueled competitors.

We believe that the prospects of a more challenging operating environment for businesses, coupled with current valuations and for the likelihood of lower returns as the capital cycle ebbs, highlight the importance of rigorous security selection. This approach involves avoiding businesses with growing obsolescence risk while allocating capital to companies that are able to use new technology to their advantage and sustain returns.

Skill vs. Biology

The professional investor isn't necessarily smarter or equipped with better tools. Their advantage lies in their training and discipline to combat more than four billion years of evolution. They are taught to run toward things that "taste bad" — underpriced assets with negative recent returns — and run away from things that "taste good" — inflated assets with strong trailing returns. At MFS, we refer to this as Time Horizon Arbitrage: a disciplined approach of exploiting the short-term, emotionally driven behaviors of others for long-term gain. ▲

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