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Acuity

The greatest wealth is **your peace of mind...**

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WEALTH MANAGEMENT

These foolish things...

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> **If I have learned anything in my 52 years in this marvellous field, it is that, for a given individual or institution, the emotions of investing have destroyed far more potential investment returns than the economics of investing have ever dreamed of destroying.**

John C. Bogle, founder of the Vanguard Group and investment legend

We are all prone to making mistakes when investing; not because we are foolish, but because we are human. It does appear that a switch inside even the most sensible person seems to flick when we begin to think about the markets, and rationality disappears in a cloud of emotion. This volume of Acuity highlights some of the dangers and provides some tips on how we can attempt to behave better. In short, the answer lies in adopting a disciplined process.

We are slaves to our behavioural weaknesses

Losing a little weight is easier said than done. We know it makes sense, yet all but the most disciplined and determined tend not to be too successful at it. This applies in many areas of our lives such as doing more exercise, stopping smoking or saving more, where we fail to control, or even modify, our behaviour. Mull over these facts that come from some research on eating (Wansink, 2009):

- On average you will eat three times as many chocolates if they are right next to you than if they are two metres away (behavioural issues: proximity, familiarity, greed).
- If you eat with one other person you will eat about one third more than on your own. If you dine with seven or more people you will eat nearly twice as much as on your own (behavioural issue: going with the herd).

Quite quickly, you can see that some simple rules would help to mitigate these negative behaviours: have less food on your plate (by using smaller plates); put temptation out of sight; have fewer large dinner parties. Similarly, when investing, by acknowledging our innate biases and our proclivity for using mental short-cuts to make decisions - known as heuristics - we can build a set of process rules that should stop us falling into the behavioural traps that lie in our path.

Investing is an emotional battle

Like being on a diet, being an investor is not easy. We have to contend not only with the erratic and unpredictable nature of markets but also the erratic and irrational way in which we think and behave. This manifests itself in different ways amongst the broad investing population: chopping and changing an investment strategy based on recent market conditions; trading shares in an online brokerage account, thinking that we have some unique insight or talent for doing so; trying to pick when to be in or out of different markets; or chasing 'hot' funds and managers. The full list is long and undistinguished. Benjamin Graham, one of the great investment minds of the twentieth century, famously stated (Graham and Dodd, 1996):

'The investor's chief problem – and even his worst enemy – is likely to be himself.'

Many – probably most - investors act irrationally, rather than rationally as economic theory would demand. Such irrational behaviour has spawned a new field of economics, known as behavioural finance. It provides us with some useful insights, some of which we will explore. Understanding these demons can help us to identify how we can try to keep them in control. The times when most investors become irrational are generally periods of market trauma or market exuberance. As Warren Buffett once said (2001), with reference to the technology stock hysteria of the late 1990s:

'The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money.'

While most investors can understand the simple concept of 'buy low, sell high', in practice their behaviour results in exactly the opposite. They are prone to being influenced by what is going on in the markets over the short term. This makes them vulnerable to being caught out as they move money from last year's bad performers to this year's hot performers.

For example, since the start of 2015, investors have faced a number of economically and emotionally worrying events: a general election in the UK and the Greek debt crisis in 2015, along with a slowdown in China's growth rate and associated market jitters, the UK referendum on Brexit and the election of Donald Trump in 2016, with a further British general election in 2017.

Emotionally, it would have been tempting to become defensive and move at least a portion of one's assets to cash. Those with fortitude, discipline and experience would have recognised this as just another period of uncertainty, where holding firm and sticking with the long-term plan made sense. A basic 60% global growth/40% defensive balanced portfolio[1] would have delivered well in excess of 20% over this period – not a bad return for inactivity.

'Absolute return' funds, on the other hand, that seek to deliver positive returns over short times frames – and which have great flexibility to position their portfolios in the face of future market events – performed very poorly, delivering a meagre 4%[2] over this period, beaten by nearly every investment asset class. Second-guessing the markets is a tricky business. Short-term, emotionally driven decisions, mixed with overconfidence in the ability to see into the future, can be extremely costly.

Understanding ourselves - and the impact of evolution - helps

As Henry Ford once said:

'There is one principle a man must follow if he wishes to succeed, and that is to understand human nature.'

To understand human nature we need to look at it in the context of our evolutionary past and the evolutionary process itself. Evolution occurs by a process of natural selection where the favourable heritable traits exhibited by an individual (defined by its genes) become more common in successive generations of a population. Physiological responses that made us run from shadows, avoid pain, devour sources of plenty in a greedy way would have been selected for. As Amos Tversky, one of the leading behavioural economists, points out (Zweig, 2007):

"Sensitivity to losses was probably more [beneficial] than the appreciation of gains…it would have been wonderful to be a species that was almost insensitive to pain and had the infinite capacity to appreciate pleasure. But you probably wouldn't have survived the evolutionary battle."

It has been estimated (Kahneman and Tversky, 1979) that humans have a pain to gain ratio in investing of 2:1; i.e. losses hurt twice as much as gains – we are risk averse, by nature.

Behavioural challenges and how to deal with them

The problem we face is that we tend to use an intuitive (short-cut) decision-making process when under a set of conditions that includes complexity, incomplete and changing information, competing goals (e.g. preserving capital today by taking little risk, but risking failure to meet our long-term goals by not taking enough risk), when we are stressed and when we need to make decisions that involve other people in the process. Intuitive decisions are not always logical and rational.

There are many ways in which human nature conspires to make our investment decision-making less than optimal and in most instances these are interlinked, compounding their negative effect. A lack of knowledge, combined with a number of illusions and biases, can lead to errors that may damage the chances of making the most from our money. These include:

- the likelihood that we take on an inappropriate and usually higher level of risk than we might have considered sensible if our assessment of the effect had been more realistic;
- the possibility that the outcome we get is not one we considered, but should have done;
- the greater likelihood that we will continue to make investment decisions rather than leaving our investments alone;
- the common and sometimes ugly outcome of blaming an adviser or ourselves when our luck runs out (Kahneman et al., 1998).

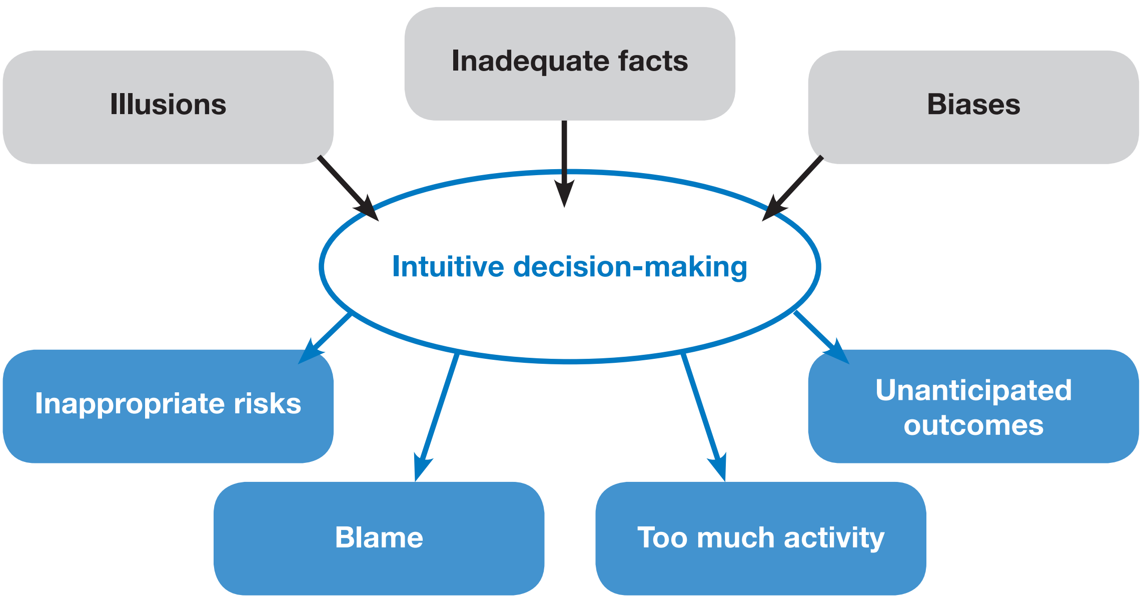

Figure 1: Intuitive decision-making can be costly
Source: Albion Strategic Consulting

All in all, not being aware of, and not curbing, our inner biases and illusions is likely to be painful, upsetting, and grossly sub-optimal from a wealth perspective. A few of the key behaviours are explored in a little more depth below. For the reader who wishes to learn more, the books by Jason Zweig and James Montier are a good place to start (see 'Further Reading' on page 6).

Trap 1: I know that I am smarter than the other fools out there

The human being is, by and large, overconfident in his or her abilities. For example, out of 600 professional fund managers asked in a study (Montier, 2010), almost three quarters said they were better than average (in the same way that 80% of us believe that we are better than average drivers).
A number of studies have shown that overconfidence leads investors to overestimate their knowledge, underestimate the risks involved and increase their perception of their ability to control events.

Mitigation strategy: Have some humility – plenty of very clever people get beaten up by the markets.

Trap 2: There is a distinct pattern emerging here

An easy-to-understand example of this behaviour can be seen on the roulette tables of Las Vegas.
A rational gambler knows that the chance of any number coming up has the same odds as any other number of coming up. Yet, a sequence of three or four 'red 9s' in a row, or other similar pattern, can create quite a stir at the table. In investing, we often mistake random noise for what appears to be a non-random sequence.

Mitigation strategy: If you detect a pattern in shorter-term data it is probably meaningless and that includes active fund performance data.

Trap 3: Problems with probability (and maths in general)

As humans, we seem to really struggle with probability calculations and outcomes. For example, many people are willing to pay more for something that improves the probability of a specific outcome from, say, 95% to 99% than from 45% to 49%, yet the two outcomes are financially equivalent. We shy away from even the simplest maths, such as working out that all-in investment costs of 2% (not unusual in the investment world) strips 40% of the expected upside of investing in equities that have returned around 5% above inflation over the long-term. While that does not seem fair, not many investors seem to do much about it, or perhaps even know.

Mitigation strategy: Do not ignore the maths. Sit down and spend a little time teasing out the numbers. (If you cannot, get your adviser to calculate the numbers for you in pounds and pence).

Trap 4: Post-match analysis – hindsight delusion

With hindsight we often honestly think we could have predicted what has happened, such as a fall in the markets. For example, the Nobel Prize winning economist, Robert Shiller (1997), undertook some research relating to the Japanese market crash in 1989. Prior to the event 14% of those asked thought that the market was overvalued, but post-event 32% thought it was. Hindsight delusion, combined with overconfidence and susceptibility to seeing trends where none exist, is a recipe for wealth destruction.

Mitigation strategy: Do not believe that you have predictive powers – it is unlikely that you do.

Trap 5: I will throw my anchor out here thanks

The human mind really likes to use 'anchors' when forming opinions, which in many cases leads to extraordinarily inaccurate estimates of outcomes. As an example, experiments undertaken by two of the most respected behavioural economists, Amos Tversky and Daniel Kahneman, used a wheel-of-fortune with the numbers 1 to 100 on it. Before asking their subjects a number of difficult questions, such as how many African nations are in the United Nations, they spun the wheel. They first asked if the number was higher or lower than the number on the wheel, and then asked for the participants guesses. When the wheel stopped on 10 the median guess was 25, but when it stopped on 65 the median number was 45.

Mitigation strategy: Do not get hooked on specific numbers, like the level of the FTSE 100 reported on the news, and then compare your portfolio to it – in all likelihood you will own a different-looking portfolio for specific and valid reasons and your returns will be different.

Trap 6: It is more familiar to me, and I get it

Humans tend toward making spontaneous generalisations, based on how they are influenced by recent events, press coverage, their own experiences, and the vividness with which a situation is portrayed. For example, most Americans believe that there are more murders in the USA than suicides, but this is not the case. The press make more of murders, night after night on the cable TV news stations, while suicides rarely get a mention.

Mitigation strategy: Do not allow yourself to be influenced by immediate and familiar events. Stand back and seek a broader perspective.

Trap 7: I like a good story

No one likes a good story more than an investor with cash to invest, and few are better story-tellers than fund managers, product sales persons and the investment press. The danger is that a narrative of a plausible sounding script, with contingent events (combining probabilities), tends to raise the probability of the outcome of the story happening in our minds to a far higher level that the reality.

Shakespeare recognised this propensity in people and made it the central theme of Othello, where a jealous subordinate, Iago, builds a web of events and inference to lead Othello into believing that his new, smitten bride, Desdemona, has been unfaithful to him. In his rage he kills her. Similar stories surround the reasons to invest in gold, commodities, vintage wine etc.

Mitigation strategy: Be a sceptic – take everything you hear or read from the industry with a pinch of salt.

Trap 8: Obsessive portfolio monitoring

Many investors find it difficult to see the long-term wood for the short-term trees. Their focus tends to be on the effects of recent market conditions on their wealth and this affects their ability to make good decisions for long-term success in meeting their lifetime purchasing power needs.

The advent of online accounts and investment tracking software has made this a lot worse and too many investors now look at their investments too frequently, getting highly excited as the markets rise and desperately disappointed as they fall. On any day, the chance of seeing a loss on your equity investments is around 50%. Even once a year you have around a 30%-40% chance or more that you will see a loss.

Mitigation strategy: Given the ratio of pain to gain, the longer the period between peeks the better! Look at the period-on-period change in the total value of your portfolio and ask yourself, or your adviser, if you are still on track in relation to your plan. Do not worry about short-term changes and certainly don't focus in on how one specific part of your portfolio has performed over a short or even medium-term timeframe. Two-steps forwards, one step back…

The solution: process, process, process.

Investing using a well thought-out, evidence-based and systematic investment process helps to reduce the emotional pressures involved. Its aim is to deliver investors with the highest probability of a successful investment outcome. That is what process provides. It does not guarantee that the outcome will always be favourable; it cannot, given the uncertainty of the markets. What it does do is to help us to make strong, rational decisions and to avoid the silly mistakes that prove to be so costly, so often, particularly chasing markets and managers in search of market-beating returns and being sucked into the latest investment fad by recent trends, plausible marketing stories and press coverage. Bad process or a lack of process has an upside outcome that is really more down to luck than judgement.

	Good outcome	Bad outcome
Good process	Deserved success	Bad break
Bad process	Dumb luck	Poetic justice

Table 1: The importance of process

Source: Russo et al. (2002)

Wise words to leave you with

Perhaps reflect a while on these wise words written by Charles D. Ellis in his excellent book 'Winning the Loser's Game' (Ellis, 2002):

'The hardest work in investing is not intellectual, it's emotional. Being rational in an emotional environment is not easy. The hardest work is not figuring out the optimal investment policy; it's sustaining a long-term focus at market highs or market lows and staying committed to a sound investment policy. Holding on to sound investment policy at market highs and market lows is notoriously hard and important work, particularly when Mr. Market always tries to trick you into making changes.'

Simple but not easy. A systematic process and a guiding hand from your adviser are the keys to success.

Further reading

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End notes

1. Portfolio: 45% MSCI World Index (net div.), 9% MSCI Emerging Markets (net div.), 6% S&P Global REIT, 40% Citigroup World Government Bonds Index (1-5) hedged to GBP. Data source: Morningstar.
2 A Targeted Absolute Return sector average. Data source: Financial Express.

Other notes and risk warnings

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