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First Quarter 2013

The True Colours of Money

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Computers certainly perform complex calculations much faster and accurately than most humans can do. Smart financial software can show us, for example, how to invest our monies for the highest possible return per unit risk, weighing up different financing options, or how much we need to save for a comfortable retirement. Undoubtedly, such tools are a great aid when confronted with financial and investment decisions in a perceived uncertain and confusing economic environment.

Yet, computers and software are not programmed to read our minds. For example, it does not understand how two actions with the same monetary value can have vast different meanings or implications. We all agree when buying a bouquet of flowers worth R100 for your loved one it has a much deeper emotional meaning and significance than simply handing over a R100 note to that person. We know it, but computers do not.

Likewise, consider the following investment decision: Two banks are offering the same term deposit investments, but at different interest rates. The bank with the lower credit rating, i.e. higher risk of defaulting, offers you a much better deal than the other. Yet, you decided to accept the offering by the bank with the lower interest rate, because you feel more comfortable investing with a "safe" bank despite the monetary or utilitarian "loss" you incurred by not accepting the higher interest rate investment.

In both instances the emotional value of money surpasses the utilitarian value thereof. But is not the only non-monetary value money may have. Consider the example where investment decisions portray social status (expressive status) besides their monetary value. Hedge fund investors typically deem themselves to be persons of higher social status and financial standing than ordinary investors who are not invested (or allowed to invest) in such structures – in the United States only persons who register themselves as investors of considerable means are allowed to invest in hedge funds – yet, it does not mean they are making smarter investment choices. On the contrary, strong evidence suggests that hedge fund investors are doing worse than ordinary investors. In addition, “exclusive club” investors have been plagued by numerous high profile investment scandals in recent years.

Meir Statman, one of the world’s leading experts in Behavioral Finance, explains in his latest excellent book “What Investors Really Want” (McGraw Hill, 2011) the different values people attach to their investment decisions and how cognitive errors and biases lead people astray from making sound investment decisions.

Statman argues that investments are like jobs, and their benefits extend beyond money, namely to enhance both wealth and well-being. A utilitarian benefit answers the question, “What does it for me?” Very much like a watch telling you the time, the obvious benefit of investments is the creation of wealth. Expressive benefits convey to us and others our values, tastes and status. It answers the question, “What does it say about me to others and to me?” For example, private banking expresses status and esteem. Emotional benefits answer the question, “How does it make me feel?” For example, the best tables at a highly rated restaurant make us feel proud, insurance policies make us feel safe, lottery tickets or speculative stocks give us hope while active stock trading is exciting.

While most of us pride ourselves in our individuality, we have strikingly similar wants from our investments. We want high returns, but not the risk (downside) of losing money. We want to banish the fear of poverty while nurturing the hope for riches. We want to beat to the market and will follow strategies that promise such outperformance. We want to feel the pride when our investments bring gains, but want to avoid the regret that comes with losses. We want fair and competitive markets, but will search relentlessly for a competitive edge to outperform the market. We want good investment advice from our advisors and expect them to render their services with due diligence and care. We want to be free from government regulations telling us how we should invest our monies, but we want to be protected by regulators against scrupulous operators. We do not want to pay taxes, and will even make suboptimal decisions to avoid tax liabilities. We want to afford the best possible education for our children and running the risk of financially over-committing ourselves in this regard. And finally, we want to leave a legacy to our children, even if it means we are under-utilising our financial assets, or we will search for high, unsustainable yields as long as we are not consuming investment capital during our lifetimes.

Obviously, some of our wants are not realistic and not mutually exclusive from each other, i.e. we cannot expect a positive outcome without running some downside risk. We need to understand and be sincere with ourselves what we really want to achieve (the underlying motive) with our investments. Even with one's best intentions not all investment decisions lead to good outcomes or are good choices. But we should endeavour to shift the balance of good choices over bad choices in our favour.

To be sure, emotional and expressive motives coupled with cognitive errors and biases can lead to a number of poor investment decisions and behaviour. We want high returns without taking the similar amount of risk, i.e. spectacular return without the possibility of spectacular losses at any given point in time. It may well be that our expectations are nestled in the favourably-skewed return-to-risk outcomes of the recent past, but are those returns really the long-term norm?

Hindsight bias, i.e. the tendency to base one's assumptions on evidence of the most recent history can bedevilled our best prepared investment plans and strategies. Also, it may lead to gross *overconfidence* in our capabilities to "read" the market – typically because we were successful following a certain active investment strategy in the recent past, we expect with near certainty the successes of the past will repeat itself in the future.

Another consequence following from our overconfidence in our investment capabilities is that investors believe that market-beating returns are relatively easy to accomplish, as if the market opinion is "mindless" or "clueless". Invariably, investors will pursue risky investment strategies that have relatively low probabilities of succeeding in the long run. Obviously, it will help a great deal to think carefully what the make-up of the market is, i.e. who are the major role players and what are your realistic chances of beating them. It will become obvious after some deliberations that market-beating returns are *not* low-hanging fruit.

Many investors think that to play the investment (more specifically speculative trading) game it is akin to play tennis against a wall where the rebound of the ball from the wall is predictable and easy to hit back. Also, the more you practise against the wall, the more you should be able to sustain long rallies. Thus, you are becoming measurably skilled at playing the game (as it will happen with most sport activities and professions).

In reality, however, the market reaction to your "shots" is not really predictable (no simple trading recipe that will win every time, exists). Also, you will not necessarily become a better player the longer you are playing the game, because the feedback you are receiving from the market is not consistent or immediate. In fact, you will have no idea who you are playing against. It might very well be against players (institutions) that have a large information advantage over an investor like you.

Yet, the "industry" is luring ordinary investors to become active traders with many "cheap", online brokerage platforms and sophisticated (not-so-cheap) technical analysis software packages at their disposal. Moreover, stock trading competitions are regularly held to crown the latest winners with some lucrative prices up for grabs. Obviously, nothing is wrong with a bit of fun and excitement out there, but be careful not to confuse active trading with serious, long-term investing as your primary wealth creator.

We are excellent in detecting patterns in our everyday lives. We can make snapshot judgements based on emerging evidence unfolding in front of our eyes, which often may be critical or even lifesaving decisions. But our pattern predictability it is not necessarily such a great asset in the investment world. Events and outcomes are much more random than we often realise or even wanted it to be. Technical analysis of the market (identifying certain price trends and behaviour) seems to work very well, on paper at least, until one realises it is not an absolutely precise market timing tool. In the real world where one incurs costs with every transaction, such small differences between optimal and suboptimal timing may wipe out gains.

In the investment industry investment returns are often expressed as return per unit risk, i.e. returns are adjusted for investment risk or volatility (the movement of prices above and below the mean) and these risk-adjusted return measures are used to gauge the desirability of an investment. For example, an investment with a high return-to-risk ratio will be superior relative to others with lower ratios.

Investors, however, are typically much more *loss-averse* than *risk-averse*, and contrary to what economic theory would prescribe (this concept is better known as *Prospect Theory*, developed by Nobel Prize winner Daniel Kahneman and Amos Tversky). It means that most investors would forsake the potential of high returns that are less likely to materialise and rather prefer an investment that offers moderate, but predictable returns. Thus, a sure gain is preferred above a speculative gain. When an investment, however, is running into losses most investors would seek more risk to avoid further losses as opposed to consolidating the position (accepting the loss). Therefore, a speculative loss is preferred above a sure loss. Investor reward-to-risk preferences basically assume an S-shaped curve and not a linear reward-to-risk relationship (Gains/Losses plotted on the x-axis and Utility/Value plotted on the y-axis).

[A special situation arises in cases where the odds of winning are extremely low, but the stakes are very high, for example, the lottery or gambling. Most people reward-to-risk preferences will turn around completely and they are quite willing to accept small, sure losses most of the times in exchange of winning big time, even if it is only a very remote likelihood].

Investor preferences have profound implications for our investment decisions and the management of investments, i.e. the returns we will realise from our investment efforts. Typically, active investment decisions – when to buy or sell – given our biased estimates where the market is heading destroy, rather than add value over time. Thus, we often pay a price for the sake of being in control or charge of our investments decisions.

Narrow framing also prevents us from seeing the bigger picture – we normally get very excited and demoralised when there is a sharp downturn in the market and will act accordingly; i.e. we sell out in anticipation of further losses. But most of the time markets recover unexpectedly and much faster from their lows than even informed opinions would have suggested. Moreover, markets are more up than down and for longer than down periods. That is the bigger picture short-term orientated investors often do not see, but long-term, patient investors will experience this “free ride” over time.

Next, consider market bubbles and the subsequent blow-ups that will occur at least once every decade in financial markets. We engage in market activities even when we know market rationality was displaced by sheer greed or fear. It is very difficult not to herd when everybody else seems very comfortable herding and making huge paper profits. We continue to buy over-priced assets in heated markets because of the “greater fool theory” – we believe someone else will buy the asset from us at even more inflated prices. Eventually, all such markets end the same with a lot of disconsolate, “I'll-never-do-it-again” investors bearing the brunt of the unwinding of market exuberance.

Finally, nobody deliberately wants to be a bad investor. Most of us are trying our utmost to do the best that we can, yet despite our sincerest efforts it does not always turn out in our favour. That is the *bad news*. The *good news*, however, is that it is very unlikely (actually impossible) that we will be perfect investors. There are simply too many mental hurdles to overcome because we are normal human beings acting emotionally as life plays out in front of us. And of course, we do not have perfect foresight what the future holds. But perhaps even the *better news* is that we surely can progress and become better investors over time. But that requires an understanding and acceptance of our capabilities and shortcomings, and then actively minimising opportunities where biases and cognitive errors may ruin our investment efforts.