your wealth

by J. Peter Hodgson CFA

EARN A PENNY FOR YOUR THOUGHTS, AND PAY A POUND FOR YOUR EMOTIONS.

Behavioural finance is the study of the human condition, as well as its impact on the capital markets. Humans are wonderfully non-linear for the most part, and this is reflected in our investment markets. It is because of this characteristic that patient methodical investors often succeed handsomely over time. Humans are quite impatient, undisciplined, self-aware, reflexive, which is why long-term investors should be grateful, as it provides superb opportunities over time. An excellent example of this was the market's negative reaction to the Government's proposed policies on Income Trusts last October. Companies (trusts) were selling at up to 30% discounts without any change in company circumstances, and for taxable investors, no change, or negligible change in taxation. The markets do not have a "risk premium" per se however they do have a patience premium.

There is a segment of our practice that involves looking after other financial services professionals and executives. They come from banks, insurance companies, brokers and investment managers. This does seem slightly odd at first glance however on careful consideration it does make perfect sense. Excellent advisors when managing their own portfolios often struggle with the very same emotional challenges individual investors do. One of the benefits to having an advisor may be the mere fact they are not the investor himself or herself. They are not burdened with biases, expectations, experience and prejudice that muddy the clear thinking required for long term wealth creation.

So what are the major emotional conditions that plague many investors? The first affliction is overconfidence. Investors often rate themselves as being above average in their abilities to understand the markets. This concept is best described as the average investor thinking they are smarter than the average investor. They overestimate the precision of their knowledge and their knowledge relative to others. Some may believe they can time the market but in reality there's an overwhelming amount of evidence that proves otherwise. Overconfidence can result in excess trading, holding on to failing positions and lack of diversification. Overconfidence also makes it very difficult to recognize where the investor's limitations are, for example foreign stocks, alternative investments and tax planning. Often the more educated the more difficult this issue can be. Market history is replete with very smart people doing very silly things with great self-assurance. Long Term Capital's demise was co-authored by Nobel Prize winners.

Defining one's limitations is probably one of the most important self-discoveries in investing. Warren Buffet had no difficulty stating he had no ability or comfort in valuing tech stocks. Overconfidence and pride are very expensive.

The next great vice is anchoring. Allowing recent past experience to dominate the sentiment and decision making process. The most vivid recollection for me was when Nortel was worth over $100/share. At the time it was unpatriotic, perhaps even heresy, to suggest that this valuation might account for all future earnings of the company, a terminal valuation if you will. Of course the justification to the contrary at the time was the recent returns and order book releases from the company.

In the absence of better or new information, investors often assume that the market price is the correct price. People tend to place too much credence in recent market views, opinions and events, and mistakenly extrapolate recent trends that differ from historical, long-term averages and probabilities.

An effective defense against this way of thinking is to compare long run returns, 10 year or more, to recent returns and ask if the recent trend is sustainable? The market does over time revert to the average returns for better or worse. The approach may also save some heartache for mutual fund selections. Too often investors chase after highly rated and touted funds while the sector that drove the returns of the fund fall out of favour.

Here are some statistics to support the importance of considering long-term past performance. The compound historical annual return for the S&P 500 from 1926 to 1999 is 11.35%. The returns for 1995, 1996, 1997, 1998 and 1999 were 37.43, 23.07, 33.37, 28.58 and 21.03% respectively. For the three-year period between 2000 and 2003, the S&P 500 had an annualized return of -14.55%, which exhibited a reversion to the mean.

The next challenge that investors face is Mental Accounting. This is to treat each security as a discrete and individual investment rather than a part of an overall portfolio. Mental accounting can have some nasty side effects. Firstly, it can lead to chasing of returns as capital is allocated to the top performing parts of the portfolio. Often at precisely the wrong time. It can also lead to holding onto losers damaging portfolio returns as it is only a "paper loss" until sold.

The late 90's give us great insight into this behaviour as investors and professionals alike placed significant assets into growth and technology driven stocks and ignored/sold value orientated funds and securities. The prevailing sentiment at the time was that Warren Buffet was a wash up, Trimark (a Canadian fund company) had lost its way, suffered major redemptions and was ultimately sold. Both were to be vindicated in just a few short years.

Of course capital was reallocated back to the value sector and managers during 2003 and 2004 only to miss the commencement of the boom in commodities.

A well-diversified portfolio should have securities that behave differently during market cycles. Sometimes that means a segment of the portfolio will underperform. The asset class that is holding you back may well be the segment that will drive performance in the future. Currently portfolios that have small international allocations will be underperforming those that do have them. Of course the time for the re-allocation to international securities was 12-24 months ago while the Canadian commodity cycle was performing strongly, a hard thing to do.

Framing is also a key struggle for investors to manage. Framing basically means that the way a problem, opportunity or question is presented will greatly influence the choice of the investor. For example if we were presented with the following choices, 80% probability of winning $100 or a 20% probability of winning $400 most investors will choose the later given the higher payoff and lack of perceived risk. Mathematically the payoff is the exactly the same and we should be indifferent to the choice.

A current example of framing and how it is used in the marketing of investment products is the way that segregated investment products are marketed. A popular feature is to commit to paying 75% of the value of the investment 10 years from now in the event of a market decline. Usually this is a basket of equity and balanced funds. There is a premium charged over and above the management fee. According to the most recent data from Andex, since 1950 there has never been a losing ten-year period for Canadian, US and broad Global Equity markets. The math says the capital protection feature over ten years has little value. The way the product is framed however makes it attractive too many investors. Figuratively speaking the protection feature is most likely an expensive financial teddy bear. The product may have some benefits that are worth looking at, but it is not the 75% protection feature.

Heuristics are the final behavioral issue we will discuss. Heuristics are rules of thumb people employ to aid in decision making to simply the process. They can subordinate a careful analytical approach to investing. The investment markets are complex structures with countless securities, strategies and theories. They make it difficult for complete analysis so we rely on heuristics. Often they can help but they do also impair our judgment.

I suffer this particular investment malady with respect to airline stocks. I was around for the initial public offer of our national airline in 1988. I witnessed the drama that has unfolded since and seen perfectly good capital thrown at a perfectly awful business and industry. To this day I cannot bring myself to invest in an airline. I also have an allergic reaction to businesses that seek government subsidies as a large part of the business plan. Perhaps one day I will miss out on a great investment opportunity. For now however, I have come to the conclusion that airline stocks are not for me.

Pogo was a popular cartoon in the US during the sixties. There is a famous sketch where Pogo returns to his friends from the swamp and says, "I have seen the enemy, and he is us!" Our emotions and experience often bring quirky, irrational behaviors that can impair returns and potentially leave a dent in your wealth. Implementing a strategy that is well thought out and sticking to it may help you avoid many of these common investing mistakes. Often working with someone else will help you do exactly that.

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