

Volume 4 //

# Acuity

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



## Why being human can damage your wealth

*IT'S INVESTMENT JIM,  
BUT NOT  
AS I KNOW IT.*



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

**Henry Ford, founder Ford Motor Co.**

## Addicted to bad behaviour

Do you remember the late 1990s - the era of tech stocks and day-trading, when sensible people gave up sensible jobs to try and make money trading on the stock market on a minute-by-minute basis? Today, with hindsight, it seems like madness. However, with new research revealing that the neural activity of an investor who is making money on their investments is identical to that of a person who is high on cocaine or morphine<sup>1</sup>, perhaps we should have a little sympathy for those who lost everything.

Perhaps surprisingly, success in investing is not about deep investment knowledge or intelligence. After all, even Sir Isaac Newton managed to lose all his money on the stock market when the South Sea Bubble<sup>2</sup> collapsed. It is about the ability to understand human nature, as suggested by Henry Ford, and to control the harmful decisions that it often drives. Warren Buffett too, concurs.

*‘Success in investing doesn’t correlate with IQ once you’re above the level of 100. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing’.*

## Are we slaves to behavioural weaknesses?

It’s often the case that, whilst we understand what we should be doing in order to improve our current and future well-being – whether it’s losing weight, exercising more, stopping smoking or buying low and selling high - we fail to control or even modify our behaviour, despite realising that we should. In fact many of the innate biases and traits that hinder our best efforts to improve are the same as those that hinder our ability to make good, rational investment decisions. As an example, here are a few facts revealed by recent research<sup>3</sup> on eating:

**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).**

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**If you eat with one other person you will eat about one third more than on your own.**

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**If you dine with seven or more 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 negate these negative behaviours – have less food on your plate, put temptations out of sight and have fewer dinner parties!

What all this has to do with investing will soon become clear. By understanding that we all possess innate and unhelpful biases and a proclivity for using mental short-cuts to make decisions (known in the jargon as *heuristics*), we can begin to appreciate the true value of a disciplined investment programme that minimises our behavioural errors.

## Investors - like moths to a flame

Have you ever wondered why moths are attracted to, and sometimes sacrifice themselves in, a flame? The reason is evolution. Moths appear to navigate using the moon as a reference point, keeping it at a specific angle to their direction of travel. They respond to artificial light - torches, candles and electric bulbs - as if it were the real moon. In their efforts to keep the light source in the correct relative position, they end up circling in towards it. It is hard to overcome behaviours with several hundred million years of evolution behind them – some moths only learn the hard way!

Likewise, 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 favourable genetic traits become more common in successive generations. Physiological responses that made us run from shadows, avoid pain and devour sources of plenty in a greedy way would have been selected for. As Amos Tversky, one of the leading behavioural economists points out<sup>4</sup>:

*'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.'*

## Lessons we can learn from Star Trek

Mr Spock, as you may remember from Star Trek days, is half-humanoid and half Vulcan. The extreme rationality of his Vulcan genes overpowers his emotional side, making him an extremely useful member of the team at times of crisis (and probably a good investor). Dr. McCoy, on the other hand, is human and prone to all the emotional influences that affect his decision-making. We all have a bit of Spock and McCoy in us.

Unhelpfully, it would appear that the evolutionary process has conspired to make our inner Dr. McCoy override our Mr Spock. For example, imagine you are in the reptile house at London Zoo. A snake you are looking at suddenly strikes at you. Your immediate response is likely to be to jump away, despite the logical response being that there is no need to do so because it is safely behind a glass screen. In evolutionary terms, better a false positive than a false negative.

Individuals differ in the degree to which emotion and logic influence their decision making. A number of simple quizzes can very quickly sort one person from another. Try, for instance, to answer the following two questions as honestly as possible:

**How much would you pay to eliminate a 1-in-1000 chance of an immediate death?**

**How much would you need to be paid to willingly accept an extra 1-in-1000 chance of an immediate death?**

In fact, the two outcomes are the same. If you have more Vulcan genes in you, your answer, like Mr Spock's, would be *'the same amount'*. If you are more emotionally driven you may well say that you would require more for the second than the first.

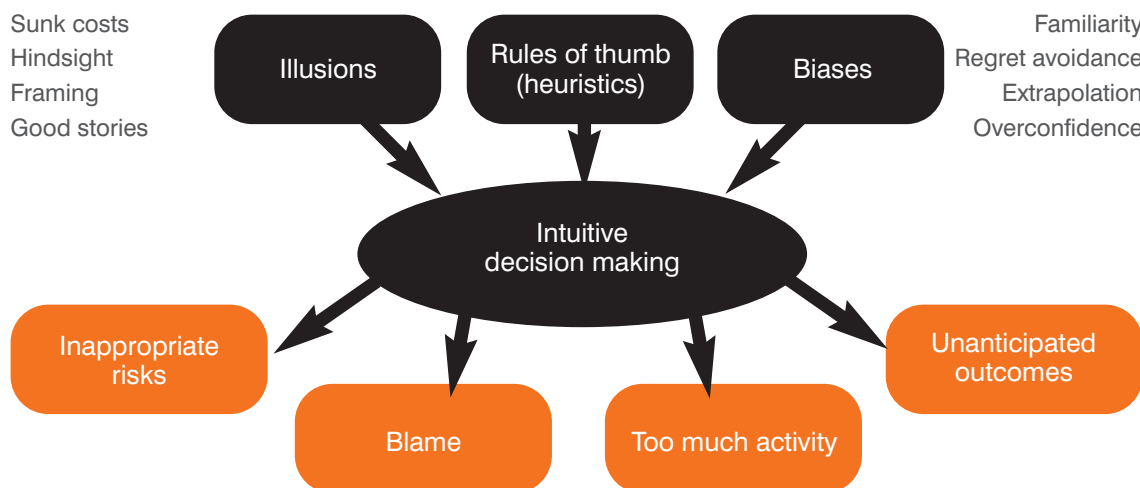
## Human nature on the rampage in investing

The problem we face is that we tend to use our intuitive decision-making process more often in circumstances that apply to the types of decisions we face as investors. These include complexity, incomplete and changing information and competing goals (e.g. preserving capital today by taking little risk, but potentially failing to meet our long-term goals by not taking enough risk). We also tend to think and act emotionally when we are stressed and when we need to make decisions that involve other people in the process.

## Key evolutionary blind spots and blinkers

There are many ways in which human nature conspires to skew our investment decision making, and in most instances these are interlinked, compounding their negative effect. A few of the key behaviours are explored in a little more depth below. If you wish to learn more, the books by Jason Zweig and James Montier are a good place to start (see footnotes).

Figure 1: Some of the many ways human nature affects investment decisions



### I know that I am better than the other fools out there

The human being is, by and large, overconfident in his or her abilities. For example, of 600 professional fund managers asked in a study<sup>5</sup>, 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. The illusion of control grows with familiarity. Overconfidence is a dangerous state of mind, encouraging investors to believe that they have better insight into future events than the market, creating the illusion that they know when to move into or out of equities, for example.

### 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 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.

### Problems with probability (and maths in general)

As humans, we seem to struggle with working through probability calculations in a logical and mathematical manner. 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 improved outcome is financially equivalent. We shy away from working out that all-in investment costs of 2% (not unusual for many active strategies) 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.

### Post-match analysis -the hindsight delusion

With hindsight we often honestly think we could have predicted what has happened, such as a fall in the markets. Experiments have shown that two groups, presented with opposing series of events leading to the same stated outcome, will both believe that the outcome could have been predicted in advance, based on the information they hold. Interestingly, when these same scenarios are presented as educated guesses about future events, participants become very less certain about their own predictive abilities.

Renowned behavioural economist, Robert Shiller, undertook some research relating to the Japanese market crash in 1989<sup>6</sup>. Prior to the event, 14% of those asked thought that the market was overvalued, a figure rising to 32% after the event. Hindsight delusion, combined with overconfidence and a susceptibility to seeing trends where none exist, is a recipe for wealth destruction.

## I'll 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 countries 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.

## Its more familiar to me, and I get it

People's generalisations are influenced by recent events, press coverage or experiences, and the vividness with which a situation is portrayed. Most Americans, for instance, 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 stations – suicides rarely get a mention. Similarly, during the residential property boom, many investors felt that buy-to-let property was a safe asset, with little risk, leveraging themselves up on the endless hype in the press and recent past experience. Add in the cocaine-like stimulation of rising investments and it is (with hindsight!) easy to see why they behaved like they did.

*'The easier it is to imagine an event or a situation, and the more the occurrence impresses us emotionally, the more likely we are to think of it as also objectively frequent'.*

Massimo Piattelli-Palmarini<sup>7</sup>

## I like a good story

Few story-tellers are better than fund managers, product sales persons and the investment press. The danger is that a narrative of fictitious events that make for a plausible sounding script, with linked events – which in reality reduce probability - tends to *raise* the probability of the outcome of the story happening in our minds. The 'plausible' story takes over from reality.

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

## The consequences of our bad behaviour

The severe consequences of allowing our inner Mr. McCoy to overcome the more rational Mr. Spock in us probably equates to about 5% unnecessary wealth destruction<sup>8</sup> every year, on average. This in turn compounds into significant differences in outcomes for Mr McCoy and Mr. Spock's investment programmes. Destructive investment decisions, including trying to 'win' by chasing managers and jumping in and out of markets, often results in buying at the top and selling at the bottom.

## Simple steps to control the power of evolution

All is not lost. While barely doing justice to the growing body of literature on how and why investors behave so much to their detriment, this brief outline has hopefully alerted you to the dangers and some of the pitfalls of giving our emotions too much rein in our decision making. What then is the solution?



## Process, process, process.

Investing using a well thought-out, evidence-based and systematic investment process helps to take much of the emotion out of investing. Its aim is to deliver to investors 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 luck than judgement.

Figure 2: The importance of process

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

Source: Russo, J. E., Schoemaker, P. J. H., (2002) Winning Decisions, Doubleday, NY: NY

## Our disciplined approach

In short, our investment process lays down a philosophy that accepts that the markets are hard to beat consistently either through market timing or stock selection. We carefully analyse and understand the risks (investment opportunities) that we wish to be involved in and those that we do not, helping us to avoid unrewarded risks and fads. We rebalance client portfolios back to the original level of risk, which forces us to be contrarian, selling out of markets that have risen and reinvesting the proceeds in markets that have performed less well. By constraining our emotions and those of our clients, we deliver considerable value.

## Conclusion

Once we are aware of the fact that we all have evolved behaviours that tend to result in us being susceptible to wealth destroying decisions, we can understand the value of investing using a disciplined and unemotional investment process executed in a systematic way. By reflecting on ourselves, we can take the first steps to becoming better investors. We leave you with some words of wisdom from John Bogle who pinpointed up the problem perfectly in an address to the Investment Analysts Society of Chicago in June 2003:

*‘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.’*

## Take-home points

- Human nature is a big impediment to successful investing
- Deep-seated evolutionary traits and behaviours leave us prone to making emotionally driven decisions.
- Our emotional selves tend to overpower our logical selves.
- Recognising a number of critical blind-spots and blinkers allows us to reflect on our behavioural weaknesses as investors.
- The consequence of our bad behaviour is considerable and is measured in wealth destruction and missed opportunities.
- A disciplined and systematic investment process can help to trump evolution and to take much of the emotion out of investing, thereby improving the chances of a successful investment experience.

We hope that you have enjoyed this paper. Please do not hesitate to call if you have any questions or comments on it, or if you would like to discuss our investment process in more detail.

## End notes

- <sup>1</sup> Zweig, J., (2007), *Your Money and Your Brain*, Simon & Schuster, NY, NY.
- <sup>2</sup> The South Sea Bubble of the 1720s was caused by the speculative frenzy stirred up by the South Sea Company, boasting of the riches that would come to investors from the exclusive trading rights in South America it had been granted in return for underwriting Britain's national debt. A whole host of speculative ventures rode on the back of the frenzy, with perhaps most extreme example of the ludicrous nature of many of these schemes being a company set up "*for carrying-on an undertaking of great advantage but no-one to know what it is.*". The subsequent crash bankrupted a wide spectrum of society.
- <sup>3</sup> Wansink, B., (2009) *Mindless Eating*, Hay House, UK.
- <sup>4</sup> As quoted in Zweig, J., (2007) 'Your Money and Your Brain', pp.132
- <sup>5</sup> Montier, J., (2010), *The Little Book of Behavioural Investing*, Wiley & Sons, Hoboken: NJ
- <sup>6</sup> Shiller, R., (1997) as quoted in the *Wall Street Journal*, June 13.
- <sup>7</sup> Piattelli-Palmarini (1994), *Inevitable Illusions – How mistakes of reason rule our minds*, John Wiley & Sons, Hoboken: NJ.
- <sup>8</sup> Dalbar *Quantitative Analysis of Investment Behaviour*, 2009

## Other notes and risk warnings

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