

# Investment Basics

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## 1. The Difference between Investment Policy and Investment Strategy

The investment of capital, whether private or institutional, entails two distinctive processes, namely the formulation of an investment policy and then the investment strategy to be followed. The former revolves around the question of what asset class selection (equities, bonds, properties and cash) to use for a chosen set of risk profiles and time horizons, while the investment strategy refers to the methods used to invest capital.

Essentially two investment strategies can be identified, namely active investing and passive investing. The former - whether done by a professional manager on behalf of investors or by an individual for him/herself - requires active and continuous decision-making about which assets to buy and sell, in order to achieve superior returns against the market average (index). This method necessitates asset selection and market timing, but comes at a price for investors; both transactional and management fees will deflate potential returns. Passive investing or index investing on the other hand, accepts the market average (index); it is not concerned with asset selection, except to minimise investment costs. This constitutes the basic difference between the two strategies: superior returns at a cost versus average returns at minimal cost.

The question arises as to which strategy is optimal or which will most effectively achieve real growth over time. Basically it boils down to whether with active investing the extent of achieving above-average returns will surpass its cost factors.

## 2. The Importance of Investment Policy

Numerous studies have highlighted the relative importance of investment policy. For example, asset allocation (investment policy) explains about 90% of the variability in a fund's performance over time (Brinson, *et al.*). Another study by Ibbotson and Kaplan, which evaluated pension plans and mutual funds in the US, indicated that asset allocation explains on average more than 100% of the typical fund's return level. Active management on average did not add any value above the policy benchmarks and after costs actually diluted performance. When evaluating the variation in returns among active funds, the differences in management (style, selection, timing, and fees) did explain 60% of the variation versus the 40% of the asset allocation decision.

The above findings are a mouthful and some careful analysis is needed to derive any value or sense from it. Unfortunately, over the years many incorrect conclusions and claims have been made - either the findings were misunderstood or misused to sell certain services and kinds of advice.

Portfolio investing requires three distinct decisions to be made. First, the decision to invest, in other words to expose your money to different investment markets; second, what weightings to give to each asset class (asset mix) and third, whether you are going to make use of active investing (asset selection and timing) or index investing (follow the market) to implement your decisions. The first two decisions are about your investment policy and the third is about your strategy, which I explained earlier on.

Brinson *et al.* found that your investment policy explains on average 90% of the variance of returns over time - but is not necessarily determining 90% of your actual return level. At first they were not very clear on what they actually meant, but as it turned out they specifically referred to the dominant influence of decision one - you cannot expect any returns if you have not invested in the market and the majority of whatever returns you will get from your portfolio are explained by market returns.

Again, just to stress a simple, but often neglected truth: the performance of an investment portfolio over time is mostly explained by the market returns of those asset classes. For argument's sake, if your portfolio yielded 15% per annum over a five-year period, the corresponding market return would have been 12% per annum (say). You, your advisor and/or active manager should take credit for that extra 3%, but not for the full 15%.

But what will distinguish your portfolio return from your neighbour's portfolio return is determined by decisions two and three, your asset mix decision and whether you are using active and/or index strategies. Ladies and gentlemen, this is the crucial part. We cannot influence the market return, but we can decide upon our asset class exposure and strategy. Guess what, there is no magic formula, despite what you might hear from "experts". You need luck, insight and knowledge and if you do not have that, you have to buy it from your investment advisor and/or active manager.

Let us turn back momentarily to the findings of Ibbotson and Kaplan; one does not expect active management strategies on average to add any value (I shall discuss these issues in more detail later), therefore their findings are not surprising. However, that does not mean that some active managers cannot add great value in enhancing your portfolio return by his/her asset mix (weightings) and asset selection decisions. Unfortunately, another group of managers is going to get it completely wrong and destroy value that you would otherwise have received from the market. Ibbotson and Kaplan's research confirmed that the wide dispersion between various investment funds' returns can be mostly attributed to decisions two and three.

A lot has been made of these research findings, yet it did not really create that much new information and knowledge, it rather confirmed these “common sense” ideas. As one commentator observed after having spent a “lifetime” in search of the “Holy Grail”: “The one thing that I’ve learned in this industry is that there are a lot of incompetent people managing vast sum of assets, but I did not really discover anything new about asset allocation.” Yes, be wary - this game is big business and is run all too often by marketing people, not investment people.

Let us have a look at some practical examples (see tables on the next page) what all the above actually mean for you as the investor:

You entrusted your investment portfolio to an active manager, who made decisions two and three on your behalf. Your total return was 14%, of which the market contributed 85% and your active manager the rest (15%) - he/she added 2.1% return because of his/her skills.

In essence this manager earned his/her money, providing it was reasonable of course! Unfortunately you will not always be this lucky; sometimes the asset mix (decision two) will be wrong and/or your active manager will get selection and timing wrong (decision three).

Criteria	Decision	Equities	Bonds	Properties	Cash	Total Return
Policy Benchmark Weights	Decision 1	70%	15%	10%	5%	
Market Return	No Decision	12%	9%	18%	7%	11.90%
Asset Mix Weights	Decision 2	60%	15%	20%	5%	12.50%
Active Manager Return	Decision 3	15%	11%	15%	7%	14.00%

### Analysis of Return Contribution

Due to Decision 1	85%	11.90%
Due to Decision 2	4%	0.60%
Due to Decision 3	11%	1.50%

### 3. What is a “Suitable” Investment Policy?

Essentially, one’s investment policy should be determined by one’s appetite for risk, which in itself is not easy to ascertain; simply, one may not be fully aware of the real risks associated with some asset class investments (see discussion later).

We know that investment risk is the flipside of investment return. Furthermore, that equity investments are more risky than property and bond investments, but according to consensus belief should yield higher returns in the long run than the latter two asset classes.

Hence, the consensus advice given to individuals is normally based on the theory that the longer the investment horizon, the greater risk one can afford. For example, a 30-year old would be recommended to have 75% exposure to equities, a 45-year old a 50% exposure and a 55-year old perhaps a 40% exposure.

The above sounds logical and sensible, yet it defies some real issues. First, what is meant exactly by “long term”, as if any investment made now will pan out to be a good investment in the long run. No, what is important to realize, is that any investment is only a good investment if it is a value proposition.

For example, if one had invested in some technology stock during the hype of the early 2000s I have some really bad news - you will probably never get your money back, let alone some returns. Or, ask some Japanese property investors who bought during their property bubble what their property investments are worth now. And so I can continue - history is rife with tales of investment disasters, simply because following the crowd and hype will do more harm than good.

Second, the “ideal” or optimal asset allocation policy is formulated after backtesting various asset allocation combinations (returns, volatilities and correlations), as if those same economic fundamentals and social moods (which drove those asset class returns) are present or will be present in the next couple of decades. No, the trick is to identify what

possible future economic fundamentals and social moods will prevail to drive asset class returns. But that can be a near-impossible task to predict accurately - even professional investment managers do not get it right.

Third, an asset allocation policy should not be cast in stone: you must be able to change the benchmark weights allocated to each asset class to benefit from hopefully correct predictions about which asset class will outperform in the near future (tactical decision-making). However, I would recommend having asset allocation ranges, not a completely “open” mandate - even the most successful and confident managers will get it wrong from time to time.

Having said that I would prefer a policy where I set myself an investment goal of “inflation plus 3-5%” (say). The actual equity allocation will be directed by prevailing cash and bond yields, but it will be unlikely to surpass 50-60%.

Why are bond and cash yields important? In the past decade, the South African Reserve Bank has followed a monetary policy of maintaining high real interest rates to counter inflation. This policy undoubtedly paid off. At the same time bond and cash investors enjoyed relatively high real yields without running major investment risks. An astute investor that during this decade significantly increased his/her fixed interest exposure relative to his equity investments would have outperformed most professionally-managed asset allocation “solutions”.

With this approach, I believe I am relatively safeguarded against large downside adjustments in portfolio valuations from one year to another. A negative portfolio return in any year will set you back more than a couple of years (as if you have never contributed during that time) compared with when you are following a moderate investment policy. It is important however to stick to the rules, and not simply to increase your equity allocation to, say, 80% because the market is having a fantastic bull run or perhaps, even worse, to base your decision on the previous year's results.

#### **4. Formulating the Investment Strategy**

As explained earlier this is about selecting the investment methods in order to achieve your investment goals. Do you appoint a professional manager, do it yourself, or use an index investing approach?

At the outset let me be clear on this: buying selected blue chip stocks and keeping it “forever” has always been my number one strategy (buy-and-hold). For example, a portfolio of stocks like Anglo American, BHP Billiton, Sasol, Remgro, Standard Bank and RMB Holdings will deliver exceptional returns over time. Yes, there will of course be times when these stocks will come under severe price pressure (as seen over the past five years), but I know that they deliver fantastic dividend growth, and if nothing else I will get my yearly dividends, escalating at a rate that few others can match. In fact, during times of price pressure it will represent an

ideal opportunity to accumulate even more of these stocks.

However, there is one prerequisite. A sizeable investment amount is needed to make it worthwhile and cost-effective to build and maintain such a portfolio. If that is not possible, you have to decide between an index investing strategy or an actively managed investment portfolio. Even if you have hundreds of thousand of rands (or millions) to directly buy your own stock, you will in one way or another be invested in a retirement fund (pension, provident or retirement annuity) where you are basically forced to use a service provider. So, in all likelihood you will have to make a decision between active and index investing.

First, most people do not even know they have a choice, and if it depends on the financial powerhouses they never will. Active investing is big business. Bear in mind that in the process of active investing, fees are charged on an ongoing basis, obviously to cover transaction, research and personnel costs, but it also includes a profit margin whether you as the investor are making money or not. Index investing also have administration and profit margin costs, but less than 50% of that of active investing. And if you are a long-term investor (five years or more) that cost differential **is** going to make a difference.

I have not yet mentioned possible upfront fees (excluding brokerage and advisors fees) that you will have to pay for the privilege of investing with an active management company. Most index providers charge no or small upfront fees. There are certainly reputable active managers out there who changed their business models to more investor-friendly structures; charging no or small upfront fees and much reduced ongoing fees, but with some performance-related fees attached. I do not mind paying these since they would have delivered on their promise (provided I agree with their performance benchmark). The payment of advisor fees merits a discussion on its own, but if you are using your advisor or agent simply as a distribution channel you are wasting your money - there are cheaper distribution channels, like going direct or "online".

Second, what strategies are being employed by index funds and active managers? In the case of index investing the answer is quite simple: there is no strategy. What you see is what you get: the aggregate return from predominantly the largest listed companies. The performance by a relatively small company in the index is overshadowed by the returns of the dominant players in the index. An active manager's portfolio will be more equally-weighted, that means stocks in the portfolio have more or less equal impact on returns. In this case the exceptional performance by a relatively small company will make a difference to the overall portfolio return. That may well be a serious constraint on exclusively using index investing in your investment strategy.

However, there is one big reason why I like index investing. It fits near 100% my investment philosophy of "buy-and-hold", which I described earlier. I want exposure to the blue chip companies, even if just for the yearly dividends and eventual dividend growth. I am also not

interested in playing “trading games” (market timing). I believe (and know) index investing is the cheapest way of achieving this.

A special kind of indexation that is gaining greater popularity among institutional investors is called enhanced index investing. The index manager may deviate slightly from the benchmark in those sectors/stocks where the most potential gains are foreseen. Outperformance of the benchmark is thus possible at relatively low costs compared with actively managed funds.

What are active managers doing? They try to outsmart the market by having different portfolios to the market benchmark. They invariably underweight the dominant counters and include more smaller companies in their portfolios. Then they also frequently trade, especially the larger counters, to generate additional returns and thereby outperforming the market. The problem with this strategy of market timing is that you will probably get it right as many times as you will get it completely wrong. Active managers can call their strategies by many names (value, growth, small cap), but essentially this is what they do.

Is the market collectively stupid, in that active managers can consistently make smarter calls than the market? This can partly be answered by looking at who constitutes the “market”: it is none other than predominantly these professional managers! I certainly do not think these professional managers are stupid, neither collectively nor individually, but they are human beings after all and prone to common errors of judgement and mental herding (refer to the section on investment psychology). Therefore, at times the market will make large errors of judgement, but there are always managers around who think and act differently to significantly outperform the market. Unfortunately, it is not always the same managers that can outperform the market!

My reasoning thus far is supported by research findings, both internationally and locally. Basically, most active managers underperform the market (index) over longer term time frames, both in nominal and risk-adjusted terms. The current star performers are seldom star performers again when measured over another time frame. Index investing is not going to give you the best possible results, but it will in all probability yield above-average returns compared with those achieved by active managers. Furthermore, I believe that active managers cannot give you any additional value when it comes to investing in large cap shares, but certainly with small or medium cap shares. Basically, the large cap shares are the most researched, liquid and efficient market; very little opportunities exist that active managers can exploit which have not been recognized by the market.

I therefore believe in using both strategies, otherwise known as the core/satellite approach. But you have to make a number of important decisions. First, how much are you going to allocate to index investing (core). My research indicates anything between 30% and 60%, and the longer your investment horizon the more indexation should be used. Second, which active managers should be employed and third, which specific strategies (small cap, value, growth, sector-specific) should be used. Your selection could be based on the manager’s track record

or perhaps his or her promise to deliver. Unfortunately there is no foolproof method to identify future star performers.

Up to now we have discussed the essential elements of investing. However, there is more knowledge to gain in order to strengthen your armour. These issues will be discussed in the following sections.

## **5. Understanding Risk**

There are many definitions of risk, but it is primarily a subjective view of being exposed to an uncertain outcome. With credit to Glyn Holton, two things are important; first, the probable outcome cannot be absolutely ascertained beforehand, as it is our rather subjective view, and second, we need to be exposed to an uncertain outcome.

When we attach a probability to an uncertain outcome we acknowledge that our prediction is based on past experience, but that does not mean all possible outcomes are factored into the probability distribution, since a certain outcome might never have occurred before or we might not be aware that such an outcome could occur.

The second part of the definition refers to be exposed to an uncertain outcome. For example, a person jumping from an aeroplane at 12,000 feet without a parachute is not facing risk, because the outcome (death) is certain. However, a person using a parachute would face risk (fortunately the odds are in his favor that he will touch down safely).

Risk in the investment world is normally defined as volatility or standard deviation of investment returns. However, this might be misleading in some cases since volatility refers to the expected movement both above and below the expected mean. Any investor would welcome deviation of returns above the expected mean, but obviously not below the mean, especially if it is moving in negative territory.

Typically an equity investment would be described as having an expected return of 14% per annum with a volatility of more or less 20%. Thus, from a statistical perspective you have a more or less 67% chance that your returns would vary between 34% and -6% per annum. However, equity returns are not normally distributed, meaning that statistical inferences are seldom correct. These returns exhibit a rather leptokurtic distribution (a skewed distribution with fat tails) meaning there are probably more returns above the mean than below, but also that there are more extremely large positive and negative returns than a normal distribution could have predicted.

Thus, an equity investment can be full of surprises with more extreme outcomes than could have been envisaged. If you board this vehicle be prepared for surprises: hopefully more pleasant than unpleasant.

Hedge funds worldwide are becoming more and more popular among investors and advisors,

partly because these funds generally exhibit steady positive returns with low volatility. Herein lies some potential danger in that investors might consider this to be the “final” solution to their investment “worries”. In fact these funds may follow extremely negatively-skewed distribution strategies, meaning returns would mostly be positive, but when disaster strikes it will wipe out those funds and their investors’ monies. The jury is out whether one can consider these types of funds “low risk”.

On a practical note: most investors are not concerned with statistical metrics, they are just interested in absolute values and returns. Obviously nobody likes to lose capital, and it will not help very much at that stage telling investors that some statistical inference predicts that one is likely to lose from time to time on equity markets.

Rather, what is required? First, investors should be educated as regards the characteristics of a specific asset class so that they are well-informed about possible outcomes. Second, that your asset allocation (investment policy) should suit your needs and personality. If you are a risk-averse 30-year old person rather have a 50% equity exposure than the standard recommendation of 75%, because there is just no way you can protect capital at that kind of equity exposure. Third, you must realize that if you invest in a collective scheme (unit trusts, pure endowments, etc) the fund manager is not managing only your money and is not overly concerned about your specific needs and concerns; he/she manages the fund according to a set mandate. If that mandate tells him/her that 75% of the fund must be invested in equities at all times, that will be the case, even if the biggest bear market of all times is looming.

From the above it is apparent that most investors may need a financial or investment advisor to check and re-check their investment profile, and yes even financial advisors will need some advice about their own strategies (if you believe the media and general public, they especially do!). New legislation and practice rules relating to financial advice basically force advisors to make use of so-called “risk profile” and “needs analysis” models, which to some extent are useful, but I personally have some reservations about that. Ladies and gentleman, what you ultimately need is not only legislation and “risk profiles”, but to acquire more knowledge yourself and an investment advisor, not a product salesman.

## **6. Understanding Investment Psychology**

We are told that the state of the economy has a key influence on stock market trends, in other words there is a causal relationship between the economy and future stock market movements. In fact, rather the reverse holds true: the stock market is a leading indicator of the future state of the economy.

According to Robert Prechter of *The Elliot Wave Theorist* history cites many examples

confirming this reverse relationship. Jeremy Grantham, chairman of *GMO Asset Managers*, mentions research findings of negative correlations between economic fundamentals, such as economic growth, productivity growth, or even profit margin levels and actual stock market returns two or three years later. Interestingly enough, these same economic fundamentals are used by analysts to recommend buying a stock, as if a positive correlation exists. For example, a company achieving above-average profit margin levels is punted to be a “buy”, but if you analyze the actual returns some years later upon this recommendation you will most likely be disappointed. The point is clear: current economic fundamentals are not the be-all and end-all of stock market returns.

At this juncture It is important to realize the difference between financial markets and economic transactions. Economic transactions are governed by the Law of Supply and Demand - the cheaper an item the more willing buyers would be to buy that item. But now, is that true of stock markets? Certainly not, the cheaper the stocks, the less people are incline to buy them! Second, the Law of Supply and Demand leads to a price equilibrium of price between what suppliers are prepare to offer and what buyers are prepared to pay (*The Invisible Hand*). Again, note the difference in stock markets: issuers of new stock would like to sell their stock at the highest possible price, but investors - unlike their reasoning in economic transactions - would rather pay more for this stock than less, because if it was perceived as too “cheap”, they would rather reject the offer in fear of buying a “dog” (remember the IPO of Telkom?).

Thus, in financial markets, contrary to economic systems, price and volume tend to move together - high volumes during bull markets and lower volumes during bear markets. With economic transactions rational and objective valuation methodologies are applied, but with financial market transactions people arrive at impulsive and subjective valuations.

The reason why people act differently in these two situations can be explained by how they “think”, or to be more precise what part of the brain is being used. In economic transactions they use the rational part of the brain (“neocortex” or “neo-mammalian”) with the sole purpose of maximizing utility. The uncertainty of stock markets however, forces people to instinctively use the “mammalian” part of the brain, which means they find comfort and safety by “following the herd” - not rational, but rather emotional thinking. More often than not, this behavior eventually leads to losses: you are out of the market when you should have been in, or you are in the market when you should be moving out!

Even the most highly trained professional investors will at times rather follow the “consensus” view and not really apply rational thinking. That is obviously an important reason why most active managers underperform their benchmark. An example of how professional money managers consistently get it wrong is shown by a study that analyzed the cash portions of their equity portfolios throughout various market cycles. Whenever the market was cheap managers had high cash positions and when the market was expensive they had the

minimum cash: just the opposite of what you would expect from a strategy of “buying low and selling high”.

More food for thought is the fact that the investment theories applied today originated from economic theories. In fact, the “father” of these theories, Harry Markowitz, came from a faculty of economics. At the time no distinction was made between economic and financial disciplines. Interestingly enough, Markowitz was nearly not awarded his doctorate because Milton Friedman objected that his thesis had nothing to do with economics — perhaps he could not have been more correct!

Given the above anomalies between economical activity and financial markets, how applicable are modern investment theories to investing? And, is the training of professional money managers and advisors at all focused on aspects of investment psychology, or it is just based on understanding economical and financial models, such as modern portfolio theory (MPT) and efficient market hypothesis (EMH)? My personal view is that within five years from now an understanding of the psychology of financial markets will form a critical part of this training programme.

The changing landscape in understanding and approaching investment markets is no more evident than when Daniel Kahneman was recently credited with the highest possible award (Nobel prize in 2003) for the tremendous work he has done in the field of investment psychology.

## **7. Common Errors of Judgement**

I am always a bit sceptical when I see these long-term graphs illustrating the advantages of equity investments above any other asset classes in creating wealth. I do not necessarily dispute this, but rather, I wonder whether that is what investors actually experience. Why? Most investors simply do not employ a “buy-and-hold” strategy; rather, they act emotionally: buy more when there is a strong bull run or sell more when there is a bear run.

I recently came across a study which evaluated what returns US investors actually achieved during the strongest bull run in their history (1980s - 2000). The market (S&P 500) yielded about 13% per annum, but guess what the average investor got: only 3% per annum, because people act emotionally when it comes to investing. I have not seen similar studies in South Africa, but I have no doubt that the findings would be the same.

We are all prone to errors of judgement, whether we are amateurs or professional investors. Let us have a look at some practical examples, just to prove we are not that rational when it comes to investing (my examples are based on the work of Daniel Kahneman).

Proposition 1: Imagine you are R20,000 richer today and you have two options: A - Receive R5,000 or B - receive a 50% chance to win R10,000 and a 50% chance to lose nothing.

Proposition 2: Imagine you are R30,000 richer today and you face two options: C - Lose R5,000 or D - 50% chance to lose R10,000 and a 50% chance to lose nothing.

And your choice is....

Most people would go for option A and option D (a sure gain and a 50% probability of a loss). But is this rational? No, a rational thinker would have identified both propositions as the same, and not take different actions, like the sure thing (option A) and the gamble (option D). If the rational thinker selected option A, then he/she would have opted for option C, because the net result would still be R25,000 richer than today. With option B and D you have equal probabilities of being R20,000 or R30,000 richer.

Proposition 3: Consider the following concurrent decisions and choose between:

[Decision 1] Option A: A sure gain of R2,400 and option B: 25% chance to gain R10,000 and 75% chance to gain nothing.

And

[Decision 2] Option C: A sure loss of R7,500 and option D: 75% chance to lose R10,000 and 25% chance to lose nothing.

Your choice....

Options A and D probably seems the most sensible choice, but is it?

Consider the following:

Option X: 25% chance to win R2,400 and 75% chance to lose R7,600.

Option Y: 25% chance to win R2,500 and 75% chance to lose R7,500.

Everybody will agree that option Y is the rational choice (and it is!). Yet, do realize that option Y is nothing else but the net result of selecting options B and C in proposition 3!

I am trying to illustrate that most of us apply a narrow frame of mind: we do not see the "bigger" picture. Look at the following proposition:

Proposition 4: What cash value do you place on one gamble where you have a 50% chance of winning R1,000 or 50% chance to lose nothing?

Proposition 5: What cash value do you place on the same gamble as in proposition 4, but instead of one game you will have five opportunities?

Obviously you will place a much higher value on proposition 5; probably five times as much as on proposition 4, because of the benefits of the statistical aggregate, which make proposition 5 less risky and more attractive. But what about the following?

Proposition 6: Same as proposition 4, but with more opportunities to play the game later, although you do not know how many.

People applying a narrow frame will place the same value on proposition 6 than on proposition 4. But that is not consistent with the reason why proposition 5 is valued much higher. Proposition 6 is a real-life situation; this is how the investment game works.

Have a look at the following proposition:

Proposition 7: What sure gain will be equivalent to a gamble where you have a 50% chance of winning R1,000 or 50% chance to gain nothing?

Most people will settle for about R400. But if the winning price was to be raised to R5,000, you will raise your settlement for the “sure gain” to say R2,000. And in the same way, if you would raise your expectation of the “sure gain” if the winning price was to be R20,000, few people will settle for the initial R400. What it actually means is that you are inclined to raise your expectations as the potential profits are becoming more attractive. But that means you will be missing out on lower “sure gains” settlements and rather pursue more risky avenues.

The danger of applying a narrow frame of mind when investing, is that you are going to end up with too little tolerance for small risks, but too much risk-taking with large ones. A rational investor takes a broad view in evaluating investment decisions and make decisions with reference to a general risk policy.

Let us turn to some other common errors of judgement, namely biases:

Proposition 8: How good a driver are you: above-average, average, or below-average?

Do you know that more than 80% of people will select “above-average”? You know and I know that cannot be. Yes, as human beings we are biased in the direction of optimism and overconfidence. The bad news is that these biases lead us to overestimate our knowledge, underestimate risks, and exaggerate our ability to control events (illusion of control). Definitely not the ideal recipe for success in the investment game! As one investment guru once said: “I don’t need to play golf to remain humble, I deal with investments.”

We have often heard the expression: “Hindsight is an exact science.” The investment world seems such a simple place when every night after the markets have closed, market commentators can give such clear reasons why the market reacted that day as it did. Hindsight bias creates the impression that markets behave according to a predictable pattern, easy money is to be made and our tendency for overconfidence is strengthened.

The following example, illustrates our typical view of things and events that many times prove to be nothing more than “optical illusions” or misplaced perceptions:

Proposition 9: You are playing the national lottery and you have to choose between the following sets of numbers:

Option A:      7      14      25      33      39      48

Option B:      2      4      6      8      10      12

Everybody I know (and do not know) will choose option A; option B seems illogical: random numbers are not supposed to follow a recognizable pattern, but from a statistical viewpoint both options are equally likely to be the winning combination (tip - if you, unlike me, play the lottery rather go with something like option B, as it is unlikely that anyone else will have such a combination!).

Another example: If you want to make an investment today, say into a collective fund, your advisor will in all probability advise you to make the investment with a manager that was the top performer for the past three years. You will have no reason to doubt the advice, as he/she is placing your investment with a “winner”, a so-called “hot hand”.

I am trying to illustrate that the human mind is a pattern-seeking device. In order to survive we categorize our world into understandable bits and pieces. When we expect randomness, we do not seek order; when we do not want randomness, we seek order and will look for any information that will confirm or satisfy what we are looking for.

Regarding investments, are we looking for identifiable patterns where none or very few exist? Are we not perhaps overconfident in our judgement of uncertain events?

The above principle was illustrated by a study done in the US of hundreds of thousands of individual transactions with a brokerage firm where clients sold a stock and immediately bought another. Analysis showed that the stock they sold outperformed the stock they bought by an average of 3.4% in the first year! - enough said.

This brings me to the end of this rather lengthy discussion, although a lot more can be said, I have hopefully captured the essence of sensible and rational investing.

Ladies and gentlemen, keeping in mind all of the above (narrow framing and biases) and the relative difficulty not to fall into these traps, I want to bring home one very important point:

INDEX INVESTING IS FREE OF SUBJECTIVE AND BIASED DECISION-MAKING

