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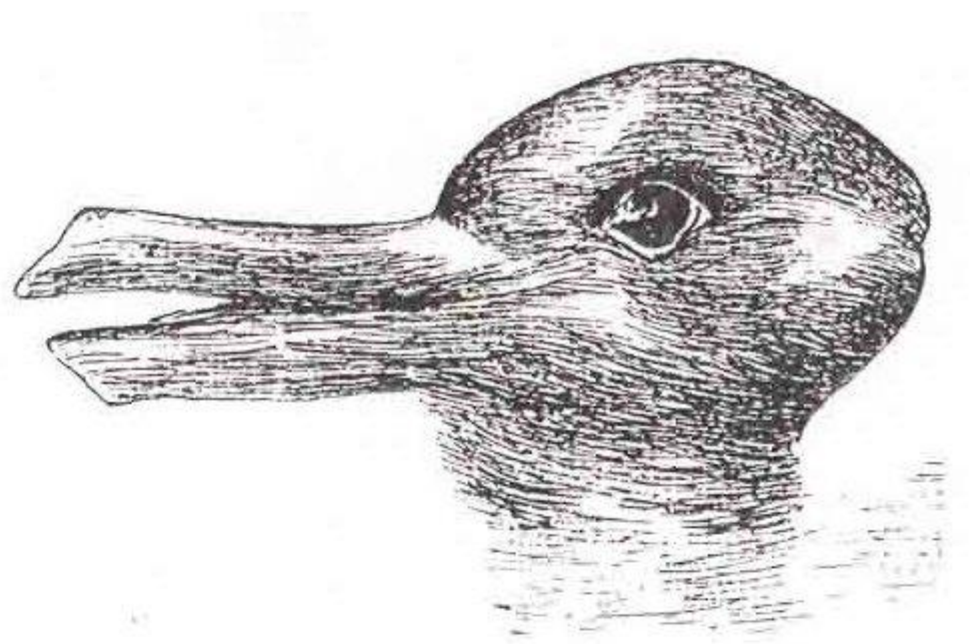
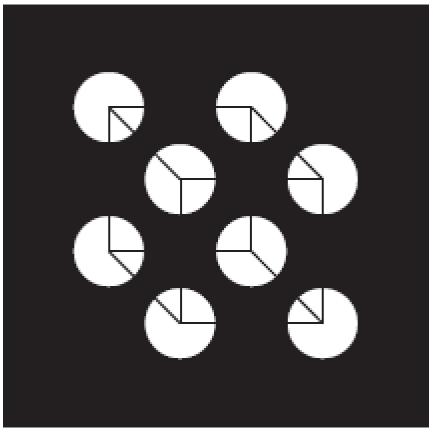
Perceptions and Investor Behaviour



Duck or Rabbit?

By Daniel R Wessels

“Not enough and too much”

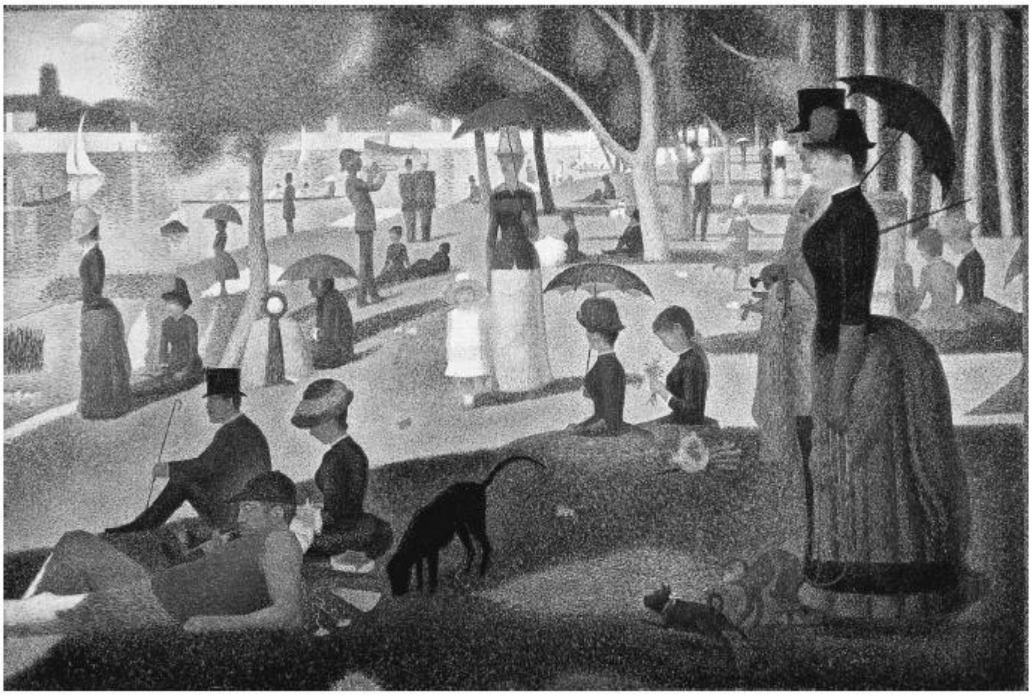


Source: Stanford University

Most people would see in the above image a cube, either floating in front of a black sheet with white circles, or floating behind a black sheet with eight holes. The cube is angling upwards and to the left or angling down and to the right. Finish and *klaar,* nothing more to it!

Or, wait a moment…maybe not. Another interpretation could be that the image has eight circles, and in each circle there are three carefully positioned black line segments. There are no lines between the circles and, in fact, there is no cube at all! But what we perceive is more than just the actual sensory information, we fill in the gaps or missing pieces to form a coherent visualisation of the image.

Next, consider situations where we perhaps are overloaded with information or stimuli. Then it is possible we might be missing or not paying enough attention to some crucial elements of the stimuli and thus forming erroneous perceptions of what really is happening.



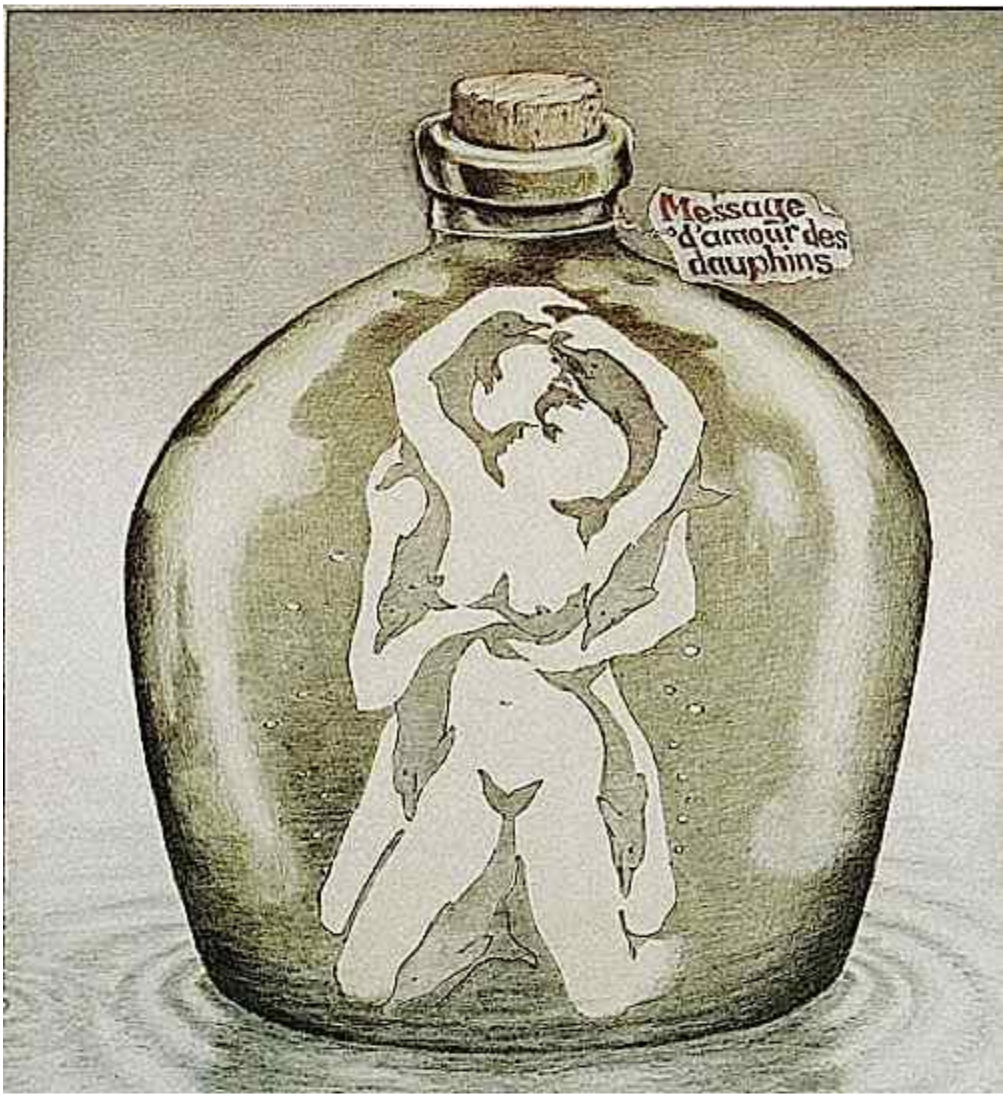
Source: Stanford University

The image above portrays a typical summer afternoon in a park with lots of activities going on. The image is not difficult to understand, but has many elements and cannot be processed in one quick glance. For example, how many dogs are in the picture? Well, you are unlikely to give an accurate answer unless you carefully search for dogs in the picture. Physically, you will move your eyes over the image, pause at different sections and fixate your gaze (bringing the specific section you want to examine towards the centre of your retina). Thus, although we can scan a large region at one time, we can only see detail information in a relatively small region.

The two problems of perception relating to sensory information, then, are “not enough” and “too much” at times. In both instances we use cognitive mechanisms (“filters”) to provide meaning and understanding of the material our senses bring to us.

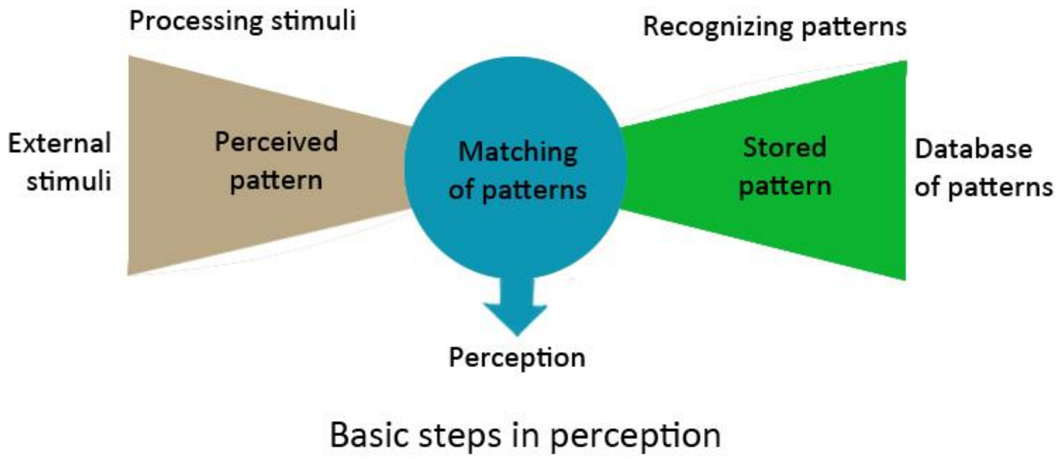
Perceptions primed by past experiences

Past experiences, memories, knowledge, and personality traits play a major role in how we “fill in the gaps” or “simplifying” the sensory information and thus making sense of it all. For example, what do you see in the next image?



If you’re an adult (or aspirant adult) you certainly see a couple making love – only when you study the image more closely you will notice that the same image could be interpreted as a number of dolphins swimming (probably only very young kids will first notice the dolphins, not a male and female in an intimate position)!

The Perception Process…



Source: www.daalmans.nl

Let us turn our attention to some investment matters and how perceptions often can led people astray in making wrong interpretations or decisions about investing in general.

"It's not my cup of tea"

A good, successful lawyer or doctor cannot be good at her profession with only a little knowledge of her field of expertise. Yet, it is not true with investing simply because you can become a successful investor with only limited knowledge about your investments. For example, you can invest in a low-cost equity index fund without any knowledge about the constituents of the portfolio, or perhaps you only have limited knowledge of, say, five out of forty stocks in the portfolio.

The truth is that you will earn the same return as your co-investor that perhaps can write a 100-page essay with detailed fundamental and technical analyses about the stocks of the same portfolio. Moreover, the “low-skilled”, but patient, “sticking-to-the-game plan” investor, in all probability, will be doing better over their investment careers than the vast majority of those “knowledgeable” investors that keep on chasing the latest, hottest, fashionable investment ideas!

“It’s not the right time”

In its simplest form investing is about doing, and not talking all day about valuation levels, P/E ratios, dividend growth rates, sustainable business models, etc. Very often investors prefer to sit on the side line, opt to wait for the “right” opportunities, and even when those opportunities present themselves later on, more “reasons” will be found to postpone the investment decision further.

It is probably the most common and easiest investment mistake of them all, delaying the investment decision “until further notice”. Market timing very seldom works in anyone’s favour, yet one will often hear market experts proclaiming that somehow they have an inside knowledge of how markets will play out in the distant feature. Maybe those explanations sound intelligent and rational at the time, but the real test of investment intelligence is only after the fact.

“Investing is gambling”

Investors can certainly lose money on the investment markets from time to time (in fact, it is also true for any market you can think of), but longer-term investing at no stage resemble gambling and its odds of winning or losing. With a longer term investment horizon, the odds are heavily weighted in favour of the investor, but it is certainly never the case with gambling. Longer-term investors, *on* *average*, always win, whereas gamblers, *on average*, will always lose (otherwise there would never have been a gambling industry in the first place). Obviously, the payoff from gambling is huge for the lucky few, which in itself is a motivation for the masses to keep coming back for more.

The use of certain derivative products, however, in your investment strategy, which invariably will be geared towards short-term horizon trading strategies, can certainly make it much more speculative (and thrilling). The vast majority of investors, and certainly not with the bulk of their “serious monies” at stake, should not be dealing with such complex, sophisticated trading strategies. Thus, confusing gambling with ordinary investing is plainly wrong and invariably very costly in the long run.

“This investment fund yielded on average 15% return over the past ten years, therefore it must be a good investment for the next ten years”

We can study longer-term past performances as much as we like, but unfortunately it does not tell us very much what we can expect in the future. If anything, it creates, consciously or unconsciously, certain return expectations. Well, it is not much of a problem if the historical performances under review yielded relatively moderate returns, the chances are you might be pleasantly surprised on the upside if you decided to stick with the investment going forward. The real problem, however, is when you study periods of above-average market returns, which incidentally is where we find ourselves today. Somehow we expect these return numbers as the norm and will be disappointed with the investment experience if similar returns will not materialise over the same investment period in the future.

I don’t want to lose money (but gain a lot)

Nobody likes to lose money, nor does anyone willingly seek out those opportunities to lose money. Risk is inherently part of one’s life – to be alive at all involves some risk, one way or the other. Investment risk can be mitigated - for example, diversifying your investment across different strategies, asset classes, geographic regions and currencies - but it cannot be completely eliminated.

The context or framework in which a situation is presented, will play a major role in how you perceive that situation. For example, your doctor describes the success rate of a medical treatment as 90% and you would feel confident it should be successful in your case as well. But, if the doctor told you the mortality rate is 10%, you would feel that number is uncomfortably high. Clearly, both situations are the same, but you would perceive each one differently.

Likewise, the fear of losing money may override one’s sound judgement and therefore not considering investments that will keep up with the inflation rate and better over time. The loss of the purchasing power of one’s investment does not happen all at once, but gradually and later exponentially over time. Inflation will turn a rich man into a poor man. Inflation-beating growth assets, with the corresponding volatility risk, is a must-have in anyone’s portfolio.

“I’ve heard about this wonderful investment opportunity”

The print and multi-media sources focus primarily on newsworthy items, but are under no obligation to present objective advice for <u>your</u> specific situation. Also, they publish sponsored content (host shows do not necessarily invite experts based on their inequivalent expertise, but rather their advertising spend). Thus the information you get from these various sources are not the be-all or end-all of investment advice, and, in fact, it may be one-sided. The same argument applies to the investment tips received from friends and family.

One of the worst mistakes investors can make is to based their investment decisions on what they have heard or read about the prospects of investments *x*, *y* and *z* – well, the media source is not meant to be an investment advisor, it will sketch the situation that will make for worthwhile reading or viewing, but it is still the responsibility of the individual to verify whether those investments will suit her particular needs and investment risk capacities.

“This industry is a sure winner, everybody wants it, and I’m going to make a lot of money”

The history of financial markets are rife with stories of certain industries that promised huge returns, but ended really bad for most investors, typically those that joined late during the market hype. Ironically, in many instances the initial expectations of how successful the industry would be was actually met and surpassed by later developments. Consider telecommunications, the motor industry, the aviation industry, and in more recent times the IT industry and the “unsaturated” Chinese demand for commodities. In each case the fast-growing market optimism led to price bubbles right at the time most investors got sucked into the good story. Today similar expectations exist for the biotech industry. I do not doubt that ground-breaking inventions and innovations will be made, but I doubt whether the majority of investors will share in the glory.

“What is a good investment today, will be a good investment tomorrow”

Most of us realise that the world around us are changing rapidly. Likewise, our preferences for how we interact, how we do business and with whom we do business changes. We are spoilt for choice - the “only way” has become “just another way”.

Technology has changed our lives dramatically and you are able to instantly transact and interact with businesses and friends with hand-held devices on the go. Compare today's technology with that of a mere ten years ago; not even in your wildest dreams you would have thought what you can do today would have been possible. The next ten years? Expect the unexpected. The name of the game is "disruptive innovation". What was once considered "sacred ground" or "high barriers to entry" for a selected few industry players has become "open territory" for other potential entrants, even those that are involved in other industries.

For example, think of the motor industry and the drive towards clean, renewable energy sources. The likes of BMW, Volkswagen, Mercedes Benz and Toyota are household names and established car manufacturers, but watch out for Elon Musk's Tesla and "other industry" players such as Apple and Google as popular component or car manufacturers in the next decade!

Not surprisingly, changes in market leaders happen frequently as market prices adjust to the economic realities over time. For example, out of the largest 41 companies listed on the JSE ten years ago, 16 of them subsequently lost their rankings as large-cap shares. Only three of them, Edcon, Venfin and JD Group, lost their place due to de-listing (shares that are not publicly trading) activities, while the rest have been overtaken by faster-growing enterprises (Moneyweb article, December 2, 2015).

Investors in equity index funds and ETFs do not really have to worry too much that they may have "dead wood" in their portfolios since portfolio weights and stock allocations adjust and re-balance periodically to the latest market index data. It is, however, more of a concern for investors who have individual share portfolios and not aligning their portfolios with the market dynamics at play.

Finally…

Investing is actually not such a daunting prospect as we often make it out to be, in fact, it could be considered simple. But it is not easy - the problem is we are human beings; we are prone to emotions (fear and greed) and misguided motives (get rich quick). Our perceptions of investing may be very different from reality – we jump to conclusions when we do not have enough evidence at hand, or, we may miss out on some crucial information amongst the hordes of information at our disposal.

Invariably, it takes time, some experience and good advice/mentors to overcome knee-jerk reactions to the abundance of information and the ever-present lure of "high-return promises" with "little" risk made by some scrupulous operators.

Sources and further reading:

- Stanford University: Perception
  www-psych.stanford.edu/~ashas/Cognition%20Textbook/chapter2.pdf

- Boundless.com: Introducing the Perception Process
  https://www.boundless.com/psychology/textbooks/boundless-psychology-textbook/sensation-and-perception-5/introduction-to-perception-39/introducing-the-perception-process-167-12702/

And some fun images… (But true altogether)

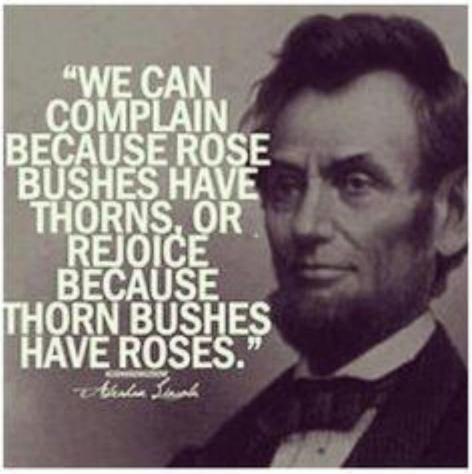
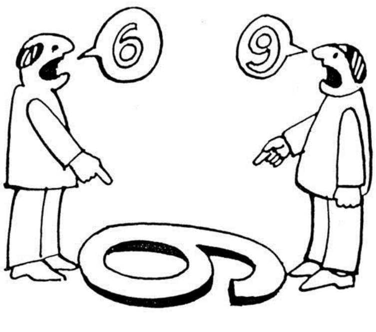


Figure 2

Impressions resist change.




DON'T JUDGE TOO QUICKLY