

ADVISORRESEARCH

Behaving Badly

This final article in a three-part series assesses the power of investors' behaviour in influencing investment outcomes and how equilibrium-based investing can moderate this behaviour

BY WESTON J. WELLINGTON

Nobel Prizes have been awarded since 1901 for achievements in chemistry, physics, literature, medicine and peace. Beginning in 1969, an additional prize in economics was introduced, known formally as the Sveriges Riksbank (Bank of Sweden) Prize in Economic Sciences in Memory of Alfred Nobel. Over the years prominent economic thinkers such as Kenneth Arrow, Milton Friedman, Friedrich Hayek and Merton Miller have been honoured for their contributions to the field. In 2002 the Royal Swedish Academy of Sciences awarded the prize to Daniel Kahneman, a Princeton University psychology professor who had never taken a course in economics, let alone taught one. Kahneman was recognized "for having integrated insights from psychological research into economic science, especially concerning human judgment and decisionmaking under uncertainty."

What does this award have to do with equilibrium-based investing and the challenge facing financial advisors in building a successful practice? A great deal. For many investors, success or failure has more to do with their behaviour than capital market behaviour. Equilibrium-based investing not

only offers a compelling investment solution but is a powerful ally in developing a behavioural solution. Financial advisors who put these twin forces to work for their clients greatly enhance their chances of success.

MODERN MAN, LIZARD BRAIN

Kahneman and other researchers have found compelling evidence that humans exhibit persistent characteristics that lead us to make poor decisions, particularly in situations characterized by complexity and uncertainty. Behavioural biases such as overconfidence, hindsight bias and overreaction to chance events induce judgment errors detrimental to our welfare. Rather than worry about the remote possibility of perishing in a plane crash, for example, we should devote more attention to the far greater chance of an auto accident and buckle our seat belt.

In the financial arena, these behavioural traits often result in costly and repeated mistakes such as excessive trading and overconcentration. "In a world where people are overconfident," Kahneman observes, "you're going to see a lot of trading. People are trading who have no business trading. They have an idea and

they act on it. But they're acting on noise." Financial advisors are guilty of similar judgment errors, attaching faulty analysis to their ability to pick winning stocks or money managers. "People are overly impressed," Kahneman says, "by the performance of money managers, who sell what they've been doing for the past few years. It is difficult to realize that you would get very similar patterns if there was no skill at all in picking stocks or in running funds."

Some market participants believe they can exploit the irrationality of others to earn excess profits. It seems plausible that some investors may behave irrationally, but it is unclear to what extent these judgment errors contaminate security prices. In any event,

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there is little evidence that professional money managers can exploit these mistakes to earn abnormal profits. And

Kahneman points out that a glaring example of investor irrationality is their confidence that markets can be outwitted. "There are so many people out there in the market. The idea that any single individual without extra information or extra market power can beat the market is extraordinarily unlikely. From this comes one of the great mysteries of finance: Why do people believe they can do the impossible? And why do other people believe them?"

AN EXERCISE IN FRUSTRATION

The structure of the investment industry reinforces investor behavioural biases. To an overwhelming extent, the business of providing financial advice rests on a belief in disequilibrium. In this view, prices for securities or even entire asset classes are frequently "undervalued" or "overvalued" and investors can enhance their returns by shifting assets from one category to another. An army of "expert" analysts and strategists provides a steady stream of opinions about what to do next – for a fee. By defining success as the ability to reliably outsmart other market participants, this approach places both clients and their advisors on a treadmill of unrealistic expectations. Clients are encouraged to switch from one strategy to another in search of the most attractive returns and advisors are tempted to promise what they can't deliver by claiming an ability to predict future events. A strategy seeking to produce

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returns greater than what the capital market is willing to supply is by definition an adversarial approach, and the resulting stress is unhealthy for both clients and advisors.

We concede the appeal of the “disequilibrium” approach cannot be lightly dismissed. Markets fluctuate, sometimes dramatically, and the potential rewards associated with clever predictions are so large that the temptation to engage in such guesswork is hard to resist. Consider the 81-year period ending December 2006. A dollar invested in cash equivalents (one-month U.S. Treasury bills) grew to \$19 while a dollar invested in U.S. stocks (S&P 500 index) grew to \$3,082. Although a simple buy-and-hold strategy for stocks was quite rewarding, what if an investor could participate in the good markets and sidestep the bad markets? Felicity Foresight, with a gift for making predictions, works two minutes a year on her investment portfolio and selects the best performer between stocks and cash for the year ahead every January 1. Felicity's dollar grows to \$206,760. And if Felicity includes volatile U.S. small company stocks in her list of choices, the “perfect timing” strategy from 1926 through 2006 turns \$1.00 into \$128 million! Although evidence of investor success with market timing is conspicuous by its absence, the lure of easy riches continues to draw new contestants. Helping clients resist the urge to speculate is part of the value advisors bring to a relationship.

NO FREE LUNCH

As we discussed in our previous segment, equilibrium-based investing presents a risk framework for developing the investment solution. By targeting multiple sources of risk and return, the poor performance of one risk dimension may be offset by strong results in another. For the 17-year period ending December 1982, for example, there was no payoff for taking equity risk: U.S. stocks underperformed riskless Treasury bills. Over this same period, however, there was a meaningful premium for holding value stocks or small company stocks. There is no assurance that small cap or value stocks will exhibit similar strength during future periods of relatively weak equity results; but since the risk factors are independent from one another to a certain degree, investors may benefit by having diversified exposure to multiple factors.

By focusing on compensated risks, equilibrium-based investing frees the client from the distraction of seeking the proverbial “free lunch” and, when

properly explained, is effective in changing clients' behaviour. With a proper understanding of risk, clients are more likely to maintain a position in an underperforming asset class than an underperforming manager. It could make sense to fire a manager; it makes a lot less sense to fire an entire asset class. Investing becomes less stressful for both the client and advisor.

EQUILIBRIUM AND ALTERNATIVES

Where do alternative investments such as private equity, venture capital, hedge funds, commodities or timber programs fit into the equilibrium world?

We cannot address the issue in detail but, in general, the equilibrium concepts discussed here apply with equal force to the world of alternatives. To the extent these risky investments are rewarded with appropriate returns, they should, at least in theory, have appeal for some investors. The difficulty boils down to implementation. Capturing a broad universe of private equity or venture capital investments at low cost is

impractical, impossible or both. Hedge funds buying and selling publicly traded securities have no special magic – they are a compensation scheme, not an asset class. As Nobel laureate William Sharpe observed, “If everybody was doing active management with hedge funds, and you put

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together all the hedge funds, what would you get? Treasury bills.”

And even if we assume that some alternative managers are genuinely skilful, it is not clear who benefits from this skill. Money management talent is the scarce resource, not investors' capital, and in equilibrium it is the scarce resource that can demand the highest return. Successful hedge fund or private equity managers will either keep accepting more and more money to manage (diluting the payoff of their research) or raise their fees. Either way, the providers of the scarce resource, not investors' capital, are likely to get most of the benefit.

Many advisors find the arguments in favour of the equilibrium investment approach persuasive but shrink away from presenting it to clients due to a mistaken belief that clients will balk at paying fees for this advice. They are apprehensive that after

ANNUALIZED RETURNS

January 1966 - December 1982

S&P 500® Index	6.81%
One-Month U.S. Treasury Bills	7.05%
Dimensional U.S. Large Value Index	11.16%
Dimensional U.S. Small Cap Index	12.39%

The S&P data are provided by Standard & Poor's Index Services Group. Treasury bill data © *Stocks, Bonds, Bills, and Inflation Yearbook™*, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefeld). Dimensional indices compiled by Dimensional from data provided by the Center for Research in Security Prices, University of Chicago.

Indices are not available for investment. Their returns do not reflect the expenses associated with the management of an actual portfolio. Returns data represent past performance and do not predict future performance.

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they educate clients on the virtues of equilibrium-based investing, clients will thank them and then pursue the idea on their own. These concerns are unfounded; financial advisors around the world applying the equilibrium-based investing approach are building thriving practices. Are some investors tempted to construct and manage portfolios on their own? Of course. And the small number of individuals with the skill, motivation and temperament to be successful should be encouraged to do so. But a far more common reaction from clients is relief they have finally found a trusted advisor with a sustainable and profitable strategy. "Why," they often

ask, "didn't someone explain all this to me twenty years ago?" The overwhelming majority of wealthy investors appreciate guidance in a world with more choices and sources of information than ever. And even the most sophisticated investors can benefit from this approach. Some of the largest avoidable losses in the capital markets in recent years were experienced by some of the most knowledgeable and successful individuals.

AN EQUILIBRIUM FUTURE

Equilibrium-based investing is not a "new" strategy nor will it be made obsolete by a flashier model next year. Almost certainly, the details will change.

Researchers will continue to improve our understanding of risk and return, and the financial industry will continue its long record of developing innovative mechanisms to hedge risks more precisely. There is plenty of work to do. Some of the biggest risks facing individual investors today cry out for better solutions – longevity risk, home ownership risk, even human capital risk (your job is outsourced to India). The financial world is destined to grow even more complex in the future, offering more tools but also more opportunities for individuals to make poor decisions. For advisors seeking to build a rewarding business, the future has never looked brighter, and a

rigorous risk-based equilibrium approach provides the strongest foundation to capitalize on the opportunity. **AER**

Weston Wellington is a vice-president of Dimensional Fund Advisors. Dimensional applies academic research to the practical world of investing. Headquartered in Santa Monica, Dimensional manages more than \$140 billion in assets worldwide as of Dec. 31, 2006 for institutional investors and the clients of selected financial advisors. Dimensional was founded in 1981 and opened its Vancouver office in 2003 to provide Canadian investors with access to a broad range of equity and fixed income strategies.

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