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Big picture investing: taking everything into account

"Investing isn't supposed to be easy."
Howard Marks, Oaktree Capital Management

At our last roadshow of 2015, we opened the presentation with this statement by Howard Marks from Oaktree Capital Management.

In January last year, in an article entitled "Emotion and decision making", the authors reminded us that:

*'A revolution in the science of emotion has emerged in recent decades, with the potential to create a paradigm shift in decision theories. The research reveals that emotions constitute potent, pervasive, predictable, sometimes harmful and sometimes beneficial drivers of decision-making.'**

The market periodically lulls us into believing that gains are freely available and investment returns plentiful. The bull market that followed the financial crisis of 2008 did just that. We benefitted from rolling annual positive returns for 70 consecutive months until August last year. Six years of positive returns can make one quite optimistic about the future, and thus the period of 'plenty' provided us with more than enough confirmation that markets tend to go up. However, in less than a year, the unfolding events of 2015 shattered investor confidence and infused market participants with fear and uncertainty.

Highs and lows tend to make us emotional about investing – which isn't a good thing

It is always at the extremes of market highs and lows that we experience heightened emotions and exhibit a number of well-documented behavioural biases. These psychological biases can play a significant role in our investment success by subconsciously affecting our decision-making. The first one is overconfidence.

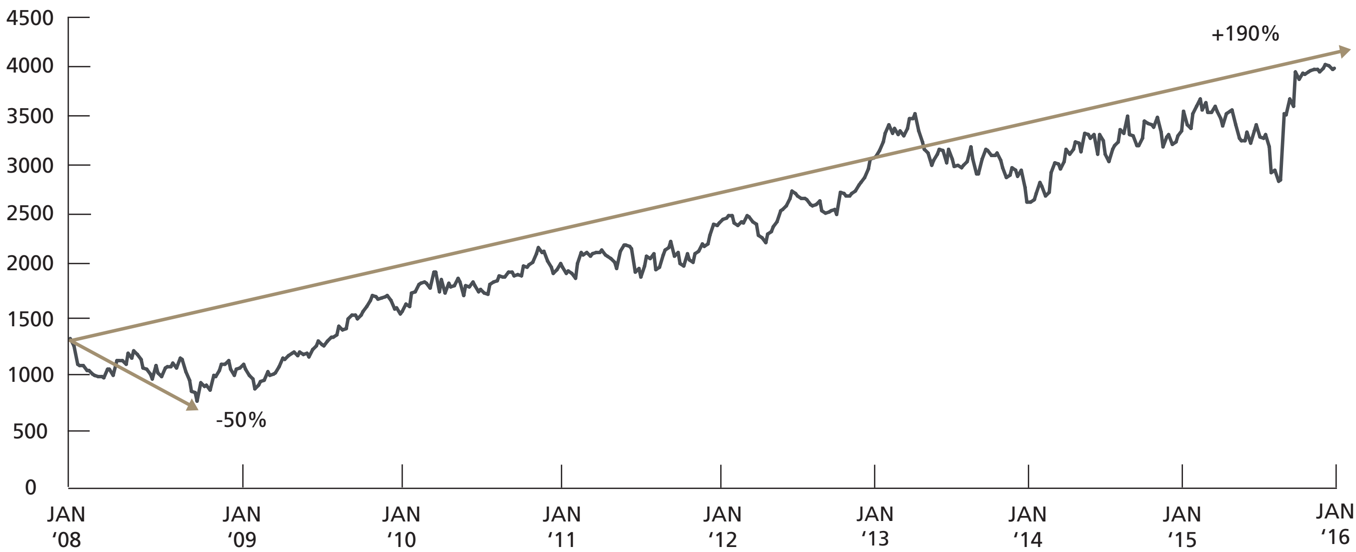
Pride (often) comes before a fall

One needs to have a rational plan to adjust your decisions when you become (over)confident. As noted in a Forbes/CFA Investment Course, confidence can easily turn into overconfidence after a few easy wins: 'Many novice investors get lucky: The first few stocks they pick do extremely well. Unfortunately, they start believing in themselves. They think they have a magic touch; or worse, they think they are smarter than everyone else. This often leads to disaster….' It is therefore important to be able to recognise signs of overconfidence in oneself and others. We hope that our investors weren't subject to this bias over the successive periods we experienced in positive markets until last year. But given its recency, it certainly gives us food for thought and cautions us when we look ahead to the future.

Investing during times of fear

Loss aversion is another common bias. The fear of losing more money can dominate decision-making. In reality, particularly during volatile times like these, it is virtually impossible to buy any investment at just the right point – its low price. Simply due to sentiment and short-term volatility, it is likely that any purchase will often look wrong before it looks right. In hindsight, investors who bought certain stocks during the first few months of 2009 now look like visionaries. But at the time, they faced several uncomfortable drawdowns in the short term. Graph 1 below shows the volatility during what turned out to be a once-in-a-generation buying opportunity.

Graph 1: South African Breweries investment growth (2008 - 2016)



Source: Bloomberg

Beware of following the herd

Another behavioural bias is herding bias. People are social creatures. In the absence of information, the time to make decisions or the discipline of following a plan, they will tend to follow the herd. Society is conditioned to believe that there is safety in numbers. When markets are volatile, instead of judiciously applying money to the opportunities that inevitably arise, fear can make people sell out and abandon their long-term plans when they see and hear their friends doing so.

We need to look beyond the latest short-term news

When fear sets in, it is easy to slip into the mode of constantly looking over your shoulder – focusing on the negatives rather than the opportunities. There is no doubt that short-term movements can continue to be startling and unnerving. If we don't have a rational plan to overcome our instinctive biases we can, unintentionally, undermine our wealth through a focus on the latest short-term news. However, as we have seen and experienced in the past, the uncomfortable decisions taken with prudent care at times like these are likely to be the ones that generate the excellent long-term performance in times to come.

Arguably the bias most investors will be suffering from currently, is recency

This bias is when investors evaluate their portfolio performance based on recent results (or their perception of recent results) and draw flawed conclusions. The conclusions can then lead to incorrect decisions. Why is this so? Recency exerts its influence in a dangerously subtle way. For example, in a memory test about a list of items, it is well-proven that people remember the last thing you told them. The concept of having a finite memory helps to explain why people remember the last item in a list, but the context we apply to our decisions is like a sum of all previous experiences (with the most recent having a disproportionate influence on us). Statistics also tend to be undermined by our 'personal' experience because the emotion of a personal experience is much more significant to us than a 'general' experience. The events of 2015 feel very personal to the majority of South Africans. Before most financial crises, the expectation of significant events that are catalysts is little to zero, but after a crisis this expectation is exponential. Recency feeds this expectation.

Prior to the events of 2015, investors had largely underestimated the likelihood of this kind of crash in our markets precisely because they had no personal experience of one induced in this way. Now, the opposite appears to be the case. Investors are overestimating the odds of a recurrence.

Our intention is not to discount this, but to rather warn investors to be aware of the negative impact that this well-documented behavioural bias can have on one's wealth.

A disciplined and research-driven investment process makes investment easier

As stewards of our clients' capital, it is our role to see beyond the short-term volatility. We must calmly assess all opportunities, make the sometimes uncomfortable decisions in portfolios, focus on the bigger picture and take a longer-term view. In addition, now is the time for us to carefully invest some of the cash we have held in our funds for exactly these type of opportunities. Instead of just blithely following the herd – the easy and popular route – we will stick to our disciplined process of searching the landscape for securities that meet our investment criteria. While this doesn't make investment easy, it most certainly makes it *easier*.

* Source: 'Emotion and Decision Making' (J.S.Lerner, Y.Li, P.Valdesolo, K.S.Kassam), Annual Review of Psychology, Vol. 66: 799-823 (January 2015)