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Acuity

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



Patience is a virtue



“ You may deride my awkward pace, but slow and steady wins the race. ”

The Hare and Tortoise, 1757. A Fable.

Patience is a virtue. So is being a tortoise.

While many investors know what they should probably do to win the investment race – set a long-term strategic plan, use high quality, low-cost funds and rebalance – too many appear to be tempted into responding to market noise and short-termism, resulting in too much investment activity. Such an approach, grounded in behavioural biases, risks losing the investment race. Being an investment tortoise is better than being an investment hare. Focusing on the long-term likelihood of success is key.

Aspire to be an investment tortoise

Aesop’s fable of the tortoise beating the hare, through its own dogged persistence and the overconfidence of the hare taking an arrogant nap, has parallels in the investing world. While we all intuitively know that ‘slow and steady wins the race’, our natural instinct is to try to make money as fast as we can, and when we do not find things going our way (usually when the markets we are invested in have fallen), or where we see a great opportunity (when other markets that we are not invested in have done better), we suffer the urge to change our rational long-term portfolio strategy. The astute investor realises that this is likely to result in a buy-high, sell-low strategy, as a consequence of chasing hot markets and fund managers. However obvious that may seem, there are more hares than tortoises, doing just that when it comes to investing.

The trouble with investing is market noise. We know that with time, we are likely to pick up a premium for owning equities relative to holding cash or bonds. We know that with time, value and small cap stocks may well deliver higher returns than the broad market. We know that with time, investing in companies operating in emerging economies is likely to deliver higher returns than investing in those in developed markets, as the risks of operating in these markets are greater. Yet for all this evidence-based insight, investors still get spooked by the noise and uncertainty that they face in the moment.

Hard Brexit? Donald Trump’s plans once in the White House? Putin’s aggression and belligerence? Isis? Syria? Falling global growth? This uncertainty about the future, and the random release of new information as unseen events occur, leads to collective uncertainty over the future earnings of companies and can result in large swings in equity prices. It always has and always will.

What turns potential tortoises into hares?

Most investors know that investing is meant to be a long-term strategy for building a pool of future consumption. Most investors know that time helps to turn bad short-term market outcomes into positive long-term outcomes. Most investors know that it is costly to buy and sell investments, incurring tax and transaction costs. But even so, many investors try to move their portfolios around, on account of short-term noise. It seems baffling why, but the answer lies in the way in which our brains are wired. We suffer a range of behavioral biases that tend us towards being hares, rather than tortoises. These include:

- **Immediacy:** this is the propensity to focus on something that is happening or has just happened, such the consequences of the vote on Brexit or the election of Donald Trump as US President.
- **Anchoring:** humans have a propensity to fixate – or anchor - on a specific reference point. This might be value of their investment portfolio at the last review with their adviser, or the performance of their portfolio relative to a market benchmark they have firmly planted in their heads.
- **Loss aversion:** we tend to feel the downside pain of losses relative to the upside pleasure of gains by a ratio of 2:1. Not a helpful trait when markets fall.
- **Overconfidence:** classic studies reveal that three quarters of fund managers believe that they are better than average¹, yet they manage around 90% of all money. Likewise 80% of us think we are better than average drivers.

These and other traits - such as herding, seeing patterns where none exist, hindsight delusion, being a sucker for a good story – conspire to turn well-intentioned tortoises into hares.

The consequences of being a hare

Some of the common investment actions that define investment hares include: chasing hot markets, sectors, themes and managers; being shaken out of investments after they have fallen; retreating back to a 'safe' cash position to lick investment wounds; being a rabbit (or should we say 'hare') in the headlights at times of extreme markets; and simply having a cocky 'I know what's going to happen, it's obvious' overconfidence and acting on these hunches.

Let's take a look at some of the latest research that identifies and quantifies where investors fail to reap the market rewards that they are due for the risks that they take. One way to do this is to take the returns that a fund publishes - i.e. reflecting say, £1, invested at the start and held within the fund across time, which is known as a time-weighted return - and compare that with the return that investors in the fund achieve, calculated to include the timing of their money flows into and out of the fund, known as the money-weighted or investor return.

The difference between the two is the cost (or benefit) of the investors' hare-like market timing actions. This is often referred to as the 'behaviour gap' and it has been widely evidenced in empirical studies. A recent piece of work in 2015² provides some interesting insights into the wealth destroying behaviour of investors, with particular insight into the value premium.

The tortoise investor knows that if he or she holds an exposure to value stocks (relatively cheaper, less healthy companies) they can be fairly confident that with time, they have a good chance of picking up a premium relative to the broad market, on account of the higher risk that comes with these stocks. They know that this premium is volatile, and that it could take quite a few years to be realised.

The hare investor, on the other hand, sees that value stocks have delivered poor returns relative to the market over the past few years (as they have done) – whilst knowing that value stocks should beat the market in the long run - and begins to question whether his or her money is better employed in something else doing better (hot market/sector/fund manager) elsewhere. They are tempted to try to time when best to be in or out of value stocks, avoiding the bad times and participating in the good times, based on some valuation driven timing signal³. Sounds like a plan, but does it work?

The results of this latest research suggest not:

‘On average, investors who invest in value mutual funds do not benefit from the excess returns reported by those funds because of the timing of their allocations...In fact, over periods with a documented high value premium, the average value investor in mutual funds has actually done worse than a buy-and-hold investor in an S&P 500 Index fund!’

It appears that the tortoise in them rightly seeks out value stocks, but the hare in them wants to get in and out to make more money. Those who invest in funds, seeking out the premium, paradoxically prize value stocks when they are expensive and shun them when they are cheap. This behaviour costs them about 1.3% per year in returns foregone, representing a large chunk of the value premium they were hoping to capture in the first place.

Those who invest in growth funds (possibly more hare-like investors), investing in faster growing and often more seemingly glamorous stocks, seem to do even worse, giving up around 3% per annum, due to their flighty timing decisions. The behaviour gap is clearly illustrated across different cohorts of investors, as the table below illustrates:

Category	Money weighted Investor return	Time weighted* Fund return	Difference
All funds	6.87%	8.81%	-1.94%
Growth funds	5.22%	8.38%	-3.16%
Value funds	8.05%	9.36%	-1.31%
Small-cap funds	8.23%	9.78%	-1.55%
Large-cap funds	6.76%	8.66%	-1.9%
Index funds	6.95%	9.66%	-2.72%
Active funds	6.85%	9.73%	-2.88%

Table 1: Time vs money weighted returns – US mutual funds Jan 1991 to Jan 2013

Source: Hsu et al. (2015). * Equivalent to buy-and-hold.

It is also worth noting that investors in index (passive funds) are also prone to bad market timing decisions; they give up almost 3% p.a. When the after-inflation, annualised return of equities has only been around 5%, on average, since 1900⁴, that is a ridiculous waste of money with severe consequences for the future ambitions of the investor. Avoiding this trap requires a disciplined, systematic investment process and an adviser who ensures that his or her clients stick to the plan of buy, hold and rebalance. Those owning actively managed funds are no better.

The benefits of being a patient and dogged tortoise

A recent piece of research⁵ provides us with a useful insight that clearly demonstrates the challenges of being a hare and the benefits of the patience and doggedness of the tortoise.

It calculated the historical data series of monthly (real) returns from January 1975 to August 2016 for a hypothetical GBP-denominated global balanced – 60% equity, 40% bond – portfolio⁶. The chart opposite illustrates the variation in monthly returns throughout the year and across years from January 1975 to August 2016. Each dot represents a month’s performance after inflation. The volume of short term noise is loud.

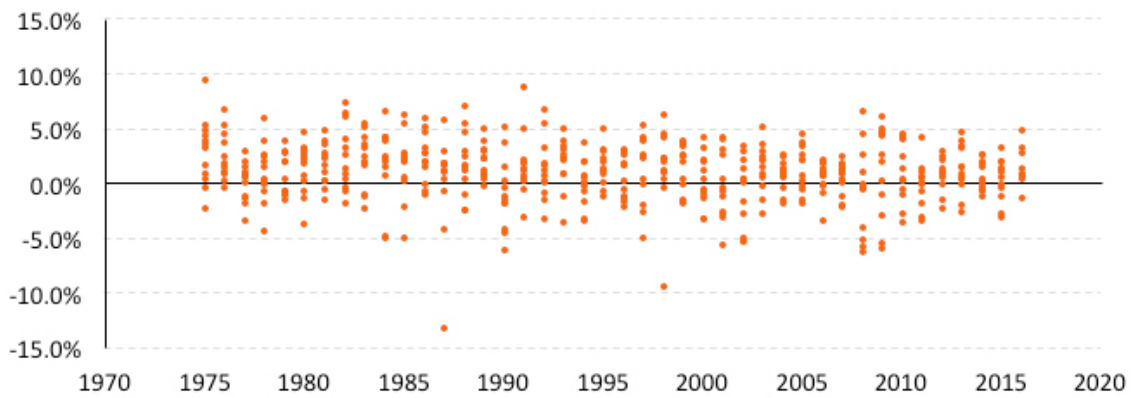


Figure 1: Monthly real return distribution by calendar year – Jan 1975 to Aug 2016

Data: Dimensional Returns Program

This single investment life returned 6.6% a year, above inflation, over the period. However, we know that future periods may deliver more or less return. It would be useful to estimate the range of outcomes investors in this type of portfolio might experience, based on how long they hold the portfolio for.

A statistical method, called bootstrapping, allows us to do just that by creating new samples of data by randomly picking from the actual sample set of data points above. Imagine a big bowl with balls in it – like the lottery draw – each marked with a monthly performance data point from the actual sample from January 1975 to August 2015 (the dots in the chart above). Bootstrapping is the process of randomly picking a ball from the bowl, recording what the data point (monthly return) is, and then returning the ball to the bowl and repeating the process. This study created ten thousand 1, 5, 10 and 20 year investment lives (outcomes) using this technique. The data shows – as one might expect – that time (and patience) help to reduce the risk of losing purchasing power and capturing a successful outcome.

One can see that in the figure below that in any one-year period, a 60/40 global balanced portfolio has around a 1/3 chance of suffering a loss of purchasing power. Enough to make any hare jittery. The benefits of holding firm grow over time as the following charts show.

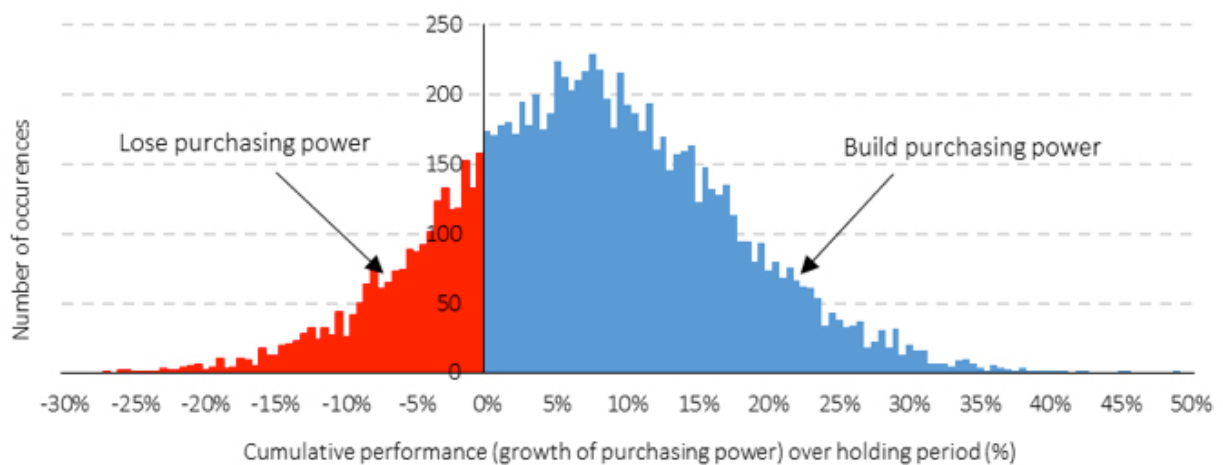


Figure 2: Annual cumulative real performance – the hare's nightmare

Note: 10,000 simulated 1 year periods using monthly data from the Jan 1975 – Aug 2016 data set.

Source: Albion (2016).

With a five year holding period (below), the majority of 'lives' deliver positive purchasing power growth, although some do not.

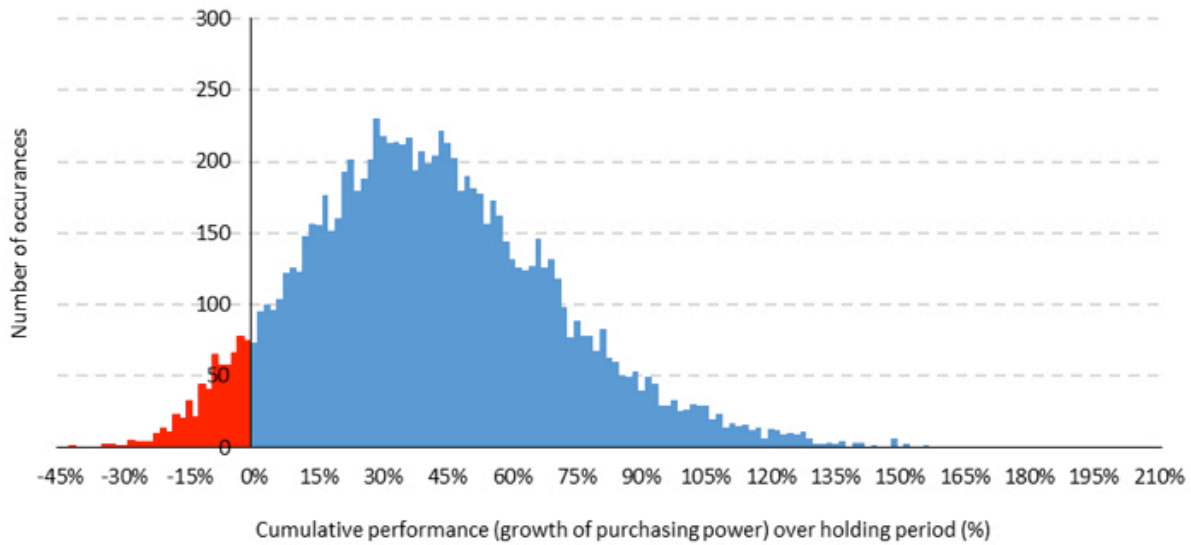


Figure 3: Five-year cumulative real performance – transforming from hare to tortoise

Note: 10,000 simulated 5 year periods using monthly data from the Jan 1975 – Aug 2016 data set.
Source: Albion (2016).

With a ten-year holding period (below), only a few investment outcomes do not deliver growth in purchasing power.

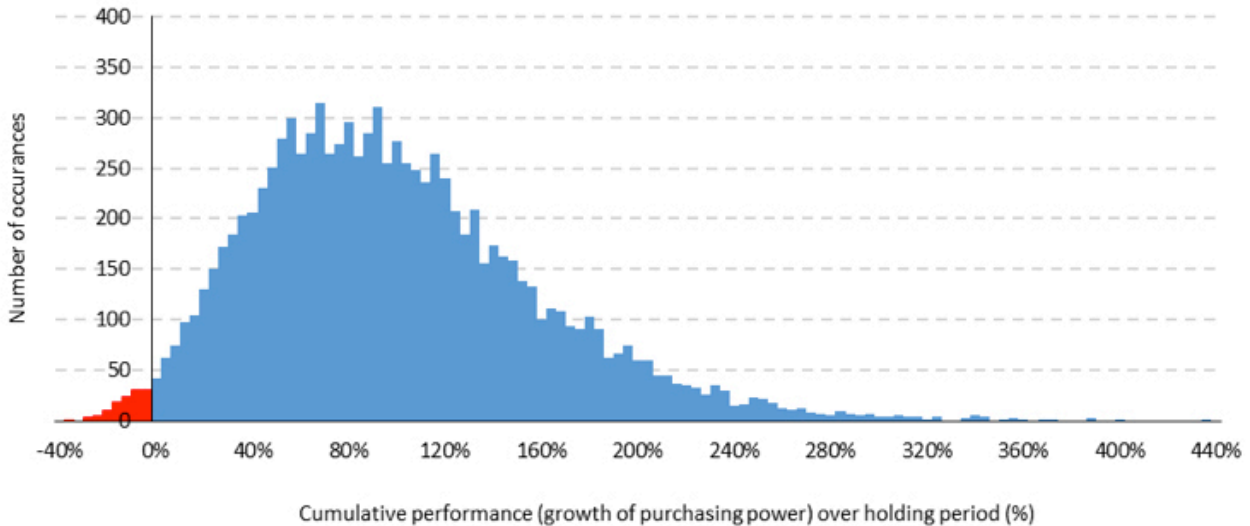


Figure 4: 10-year cumulative real performance – the tortoise nears the line

Note: 10,000 simulated 10 year periods using monthly data from the Jan 1975 – Aug 2016 data set.
Source: Albion (2016).

Over a twenty-year holding period, there is an extremely low probability of suffering an erosion to purchasing power. Holding firm is likely to deliver a successful investment outcome, without the activity and ultimate disappointment suffered by the hare.

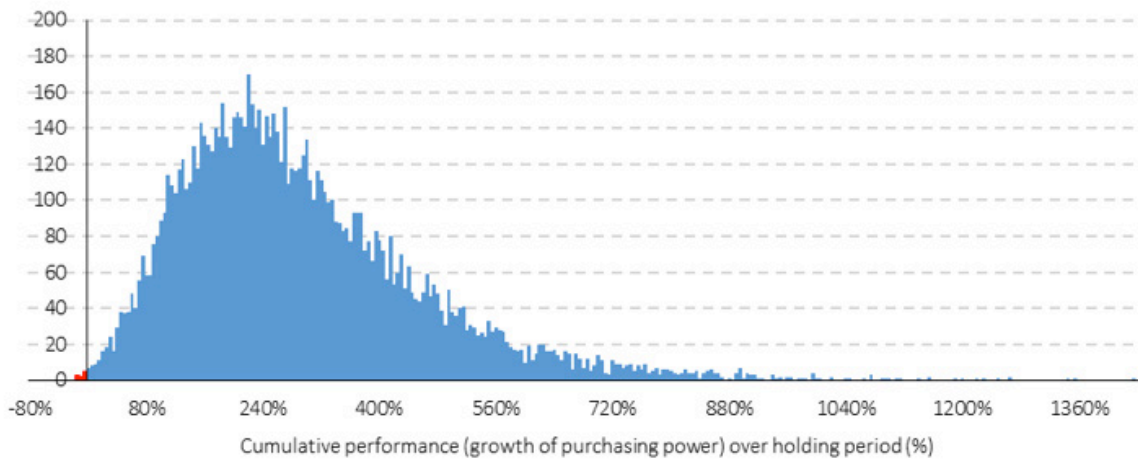


Figure 5: 20-year cumulative real performance – the tortoise wins the race

Note: 10,000 simulated 20 year periods using monthly data from the Jan 1975 – Aug 2016 data set.

Source: Albion (2016).

In conclusion

For those who recognise a bit of the investment hare in themselves, focusing on sticking to the plan of buy, hold and rebalance, will pay dividends. Patience, discipline and fortitude are the difference between winning and losing.

Tips to help you win the race include avoiding looking at your portfolio too often, ignoring the news, and recognising that in the world of investing, activity is nearly always in surplus. And remember:

‘You may deride my awkward pace, but slow and steady wins the race.’

Robert Lloyds - The Hare and Tortoise, 1757. A Fable.

End notes

1. Montier, J., (2010), The Little Book of Behavioural Investing, Hoboken: Wiley & Sons.
2. Hsu, Jason C. and Myers, Brett W. and Whitby, Ryan J., Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies (May 1, 2015). Available at SSRN: <https://ssrn.com/abstract=2560434>
3. One potential timing signal is the value ‘spread’, being the valuation measure - say B/M - of the long portfolio (value in this case) divided by the measure of the short (growth) portfolios used to construct the value premium. Greater spread tends to lead to a higher premium.
4. Barclays Equity Gilt Study, 2016
5. Albion Governance Update, October 2016 (in-house proprietary research)
6. Proxy indexes are as follows: 40% global equity = MSCI World Index (net div.); 10% global value = Dimensional Global Large Value Index; 10% global small cap = Dimensional Global Small Index; 40% short-dated, high quality bonds = Dimensional Global Short-Dated Bond Index (hedged GBP), rebalanced annually, no costs deducted, but after inflation.

Other notes and risk warnings

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