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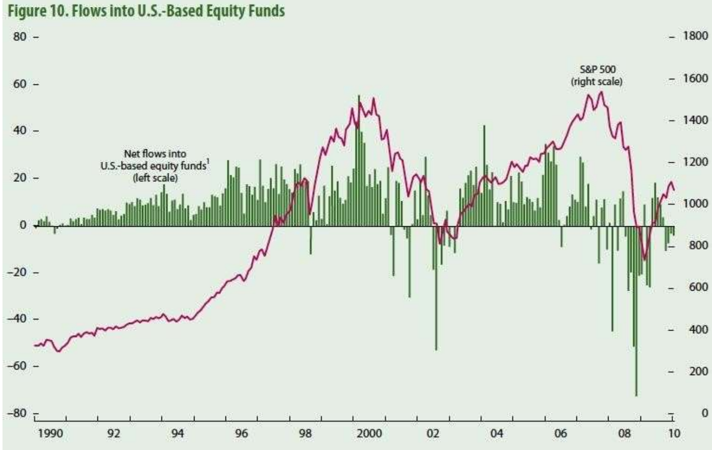
A Tale of Two Selves

Warren Buffett has frequently given what we consider to be the most valuable and underfollowed investment advice of all time: "*Be fearful when others are greedy, and be greedy when others are fearful.*" Although this seems both obvious and simple, the reality is that, despite the wisdom of this advice, it is extremely difficult to put into action, for the simple reason that we are all human; we have emotions and those emotions sometimes lead us astray when it comes to investment decisions, especially when the majority of those around us are following the greedy impulse to acquire or the fearful urge to sell. The presence of the herding instinct, combined with these two powerful emotions is, we believe, the main driver of the inconsistency between the risk tolerance that investors believe that they have and the actions they have taken over the past few years. On the one hand, many investors insist that they have a high risk tolerance and understand that higher returns will be achieved over the long run in equities, even though the returns come at the price of volatility. They also profess a willingness to accept this reality to generate higher long-term returns. The problem is that these investors have not really heard the advice of Mr. Buffett. As shown in the chart below, most investors invest when the market is doing well and exit when markets are weak, with the result that these ill-timed decisions cost them returns. In 2010, Morningstar found that if mutual fund investors in 2000, as a whole, had simply bought and held their mutual funds for 10 years, their investment outcomes would have improved by an average of 1.6% per year.

Figure 10. Flows into U.S.-Based Equity Funds



Sources: Investment Company Institute; and Datastream.
[1]In billions of U.S. dollars.

The natural question is: why do investors believe that their risk tolerance is higher than it turns out to be? We believe that this inconsistency is related to something that we have long argued at Sionna, which is that the markets reflect investors' human nature as much as underlying fundamentals.

The Myth of Rationality

Standard economics assumes that we are rational – that we know all the relevant information about our decisions and that we can calculate the value of the different options we face. The result is that we are assumed to be making logical and sensible decisions. However, any market participant over the past three or four years will tell you that this is just not the case. Research in human behaviour has identified that we each actually have two selves: one is intuitive and automatic while the other is more methodical and analytical. Standard economics refers exclusively to the methodical and analytical self, and we also tend to believe that is how we make decisions. It is the analytical self that is engaged when we construct our investment policy based on our rational understanding that equities will have higher returns than lower volatility assets over a long time period. What we may ignore is the impact of our emotions – our intuitive and automatic self – on our actual investment decisions.

A study by Antonio Damasio of the University of Iowa and George Loewenstein of Carnegie Mellon University provides some insight into why investors make decisions that are inconsistent with their rational strategies. The scientists invented a simple investing game, which they played with one group that had suffered damage to some part of their emotional brain, and another group that did not have such damage. In each round, subjects had to decide between two options: invest $1 or invest nothing. If the participant decided to invest, the experimenter would then toss a coin. Heads meant the subject would lose the $1 that was invested; tails meant that $2.5 would be added to the subject's account.

The rational decision in this game would always be to choose to invest, since the expected value on each round is higher if one invests; however, this is not what subjects did. Those subjects with an intact emotional brain chose to invest less than 60 percent of the time. Furthermore, the willingness to gamble plummeted immediately after a loss – this recent loss scared the subject and they had the tendency to decline playing further. Subjects with damage to their emotional brain, on the other hand, chose to invest over 80 percent of the time, were more resistant to the effects of a recent loss, and gained significantly more money than other subjects.

An important takeaway from this study is that the research shows that people *dislike losses twice as much as they enjoy gains*.

How Sionna Reduces the Emotional Impact of Investing

The reality that emotions cause markets to behave irrationally has numerous implications for Sionna. The first is that long-term equity market returns apply only if a portfolio remains invested throughout the volatility in good quality companies, chosen according to a rational and disciplined process. (As numerous investors sadly learned during the financial crisis, being overcome by fear and selling at the wrong time can have a disastrous impact on long-term returns.) Second, downside protection is more important to good long term returns than plunging into a volatile market in an attempt to achieve the highest possible return in any given year. Limiting downside is critical to providing protection to clients' capital and helping them to stay the course.

This conclusion is supported by a 2005 Morningstar study, which examined 10 years of returns for 17 categories of stock funds. In each category, the actual returns — after taking into account ill-timed buying and selling — fell short of the predicted returns. More stable (rational) funds performed better; more volatile (emotional) funds performed worse. In effect, in the long term, it is not only the end result that matters; you must also take into consideration the path that you take to get there.

Sionna always aims to protect client capital by a disciplined commitment to our rigorous process. Our value proposition to clients is that we tend to provide downside protection in times of market weakness, reducing the volatility of performance, and making our clients comfortable as they stay invested for the long term.