Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

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Investment Newsletter – January 2006

Portfolio Performance

We've had a great year for our portfolio investors. The Long Term Value portfolio was up about 25% in 2005 and, as of January 31st 2006, is up more than 34% since inception back in March 2005. Comparing that to the 8% return of the S&P 500, I think clients are doing quite well. Unfortunately, not all their money is in this portfolio. I typically recommend that 20% go into the Special Situations portfolio. The Special Situations portfolio has not performed as spectacularly as Long Term Value but it is still up 22% since its inception – most of that coming this month. As I've said before, past returns may not be repeated. I will however, do my best to maximize returns over the long run.

Now that I am managing client money, I tend to hold more positions and watch them more closely. In the process I've learned a few things. Over short periods, the portfolio is more volatile than I predicted. This is really a function of the number of positions held. I have come to realize even more than before that short term market moves are not a true measure of risk when you are investing over a long period. Fortunately for me, my clients haven't had to wait all that long for the big up moves.

The Psychology of Investing

In academic circles, hypotheses about the way markets work have historically been dominated by quantitative models that assume economic agents (you and me) use all information available to make rational decisions to maximize our well being (wealth). In this model of the world there is no room for investors to consistently outperform the market because all relevant information is reflected in asset prices; thus they are deemed efficient. If this is true, the best strategy is to hold a well diversified portfolio and minimize your investing costs. This is the rational behind index funds.

When I was in the Ph.D. program at Berkeley, the new hot field of study was Behavioral Finance. This branch of finance admits that there are many agents that do not behave rationally in the sense of the traditional optimization models in finance. Rather, there are psychological factors at work that cause agents to make “mistakes” that could be avoided if they had analyzed all the information and decided logically. This was revolutionary because it implies that there is money to be made by exploiting the resulting inefficient asset prices. It took a long time for this view to become mainstream in academia because the professors who figured out the inefficiencies, left academia to get rich running investment companies. For myself, I figured out how things really worked by observing and trading miss-priced securities while working on Wall Street. As I’ve shown before, the result is consistent and significant out-performance of the market.

My point here is that the way you think about investing affects your decisions and thus your results - so it’s a good idea to understand what factors may lead you to make sub-optimal investment decisions. That way you can lean against your biases and, hopefully, improve your results. With that in mind, this month I want to share some of my thoughts on the psychology of investing.

Assessing Investments: Actual Risk versus Perceived Risk

Let’s think about the connections between uncertainty and risk. First, I want to make a distinction between what I’ll call objective uncertainty and subjective uncertainty. By objective uncertainty I mean there are real world probabilities of more than one outcome. For example if you roll dice the outcome is random and statisticians can calculate probabilities of the various possible outcomes. But what if the dice were not the standard ones with the sides numbered 1 to 6? What if I told you that each die had the same number on all 6 sides? In this case, the outcome is no longer random or uncertain and thus there is no objective uncertainty. On the other hand, if you are not allowed to look at the dice before you roll them (to see the numbers on the sides) then there is still uncertainty about the outcome from your point of view. This uncertainty, which comes from our lack of knowledge of the true state of things, is what I call subjective uncertainty. Without knowing which numbers are on the dice, our subjective probability assessments are the same as the objective probabilities of normal dice (well, assuming we are rational and statistically minded).

In the world of investment management, risk is measured by looking at the probability distribution of possible returns on an investment (or portfolio). The better the estimates of this probability distribution, the more accurately risk is measured and the better will be the investment decisions where we are seeking to maximize returns for a given level of risk. Thus, measurable uncertainty is our standard definition of risk that, in turn, determines which investments are worth making. The more an investor knows about an investment’s return probability distribution, the closer he can come to choosing the best investments (in terms of highest return for lowest *actual* risk). This is because, if he overestimates the risk on an investment relative to the truth, he will end up avoiding some investments that he should make, and vice versa.

There are some situations where we really don't have much to go on in trying to figure out a potential investment's true probability distribution of possible outcomes. This feels like risk but it is not the kind of risk that we can measure in order to make rational investment decisions. It turns out, there is actually a term for this in the academic literature. It is called Knightian uncertainty (or ambiguity). Venture Capital investments are typically made under large Knightian uncertainty. This lack of knowledge about the objective uncertainty causes subjective uncertainty to be much greater than the objective uncertainty. The result is that the decision maker behaves as if they were excessively risk averse. By this, I mean the required rate of return increases drastically. Thus Venture Capitalists require returns of 10 to 20 times their money even when the best guess is that the chance of failure is 50% or less.

The most successful Venture Capitalists are those that assess risks only after they have done all they can to eliminate uncertainty (i.e. they try to get a peek at the dice). The implication for all of us is that investors who do their homework to eliminate unnecessary uncertainty will be able to see truly great opportunities when they come along. The rest of us, who try to make decisions under conditions of relative ignorance, will pass up investments that we should make if we knew the true risks. This brings us to my next point about the cost of being informed.

Information Costs and Shortcuts

Useful investment information usually costs money and, on top of that, no one has enough time to fully educate their selves about every possibility. Some people will devote considerable time to become expert on a particular class of investment so that, at least within their specialty, they will be able to see the great opportunities when they come along. The perfect example is a typical real estate entrepreneur who knows a particular area and type of property extremely well. I know people who are constantly looking in the East Bay for houses that need lots of work. They can very quickly recognize if a house will be profitable enough to justify buying and fixing it up. This may yield fantastic profits but there is a downside to such specialization. If too many competitors become equally well informed and/or the whole market in your area of specialization turns down, the good investment opportunities may disappear. Then your knowledge investment is lost and you have to find a new specialty.

Most people look for shortcuts to reduce their costs of finding the best investment ideas. One shortcut is to just look at what the crowd is doing – media hype will tell you that everyone is buying and flipping Condo's in Las Vegas for example. This is useful if the crowd is following someone who is informed AND there is some momentum in the market (thanks to the psychology of crowds). The danger here is that sooner or later it will stop being a good investment and you probably won't see it coming until you've already taken a loss. In other words the risk is changing through time and may be quite high by the time you buy in.

Another strategy to reduce the effort needed to assess risks is to just follow what your friends are doing. Whether this is useful or not depends on how your friends are assessing the risks. Someone along the way has to spend the time and money to get informed and stay informed. If you have such friends and they have a good track record, following them can be a smart strategy. Just be careful someone in the lead is doing their homework and not just blindly following the crowd.

People also like to follow the lead of celebrities if their investments are disclosed publicly. Some famous investors, such as Warren Buffet, send pretty clear signals about what they're investing in. If a celebrity investor has the resources to keep informed, following them can be a reasonable strategy. The only problem is finding out what they're doing fast enough to copy them before their action causes the prices to move against you.

But suppose you don't trust any of these methods and yet you don't have the time to properly assess investment opportunities and risks on your own. Finally, we come to my favorite shortcut. Find a well informed professional investment advisor that you trust and follow his advice. (You knew this was coming, didn't you?) The key to this and the other shortcuts is trust: finding someone you really believe is doing the homework for you.

Trust is Key

Trusting others allows us to leverage their knowledge and skills to our benefit. We use our ability to figure out who is trustworthy to solve the investment research and risk assessment problem that we may otherwise lack the ability to tackle. So what are the factors that lead us to trust someone with our money?

If you're like most people, you will judge a person's trustworthiness by their past actions. In fact, unlike investments, most people are fairly consistent in their behavior through time. Honest people don't easily go bad and bad people don't easily go honest. Similarity also inspires trust. The more someone shares our traits or history, the more we will naturally impute our own (good) traits to them. As indicated by the tendency to follow crowds and celebrities, we watch to see who others trust to decide who we should trust. Incentives to cooperate also play a role in deciding who to trust; if you feel that someone's interests are aligned with your own, you will feel more confident in trusting them.

Conclusion

The psychological aspects of investing explain a lot about the structure of the investment management industry. If everyone were perfectly well informed and analytical in their investment decisions there would be little value that specialists could add. In the real world there are many risks and opportunities that not all can assess properly. Because information costs are high, it is more efficient for us as a society to hire specialists who can use their investment in knowledge to guide many investors at the same time. Such expertise is wasted without the trust of clients: only recommendations acted upon have value. Clients need to look carefully at how they make decisions about who to trust and where to put their investment money. When working with any advisor, make sure his interests are aligned with yours and that there is enough trust to make use of his advice.

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