

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 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 eco-

nomics science, especially concerning human judgment and decision-making 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,

"Equilibrium-based investing not only offers a compelling investment solution but is a powerful ally in developing a behavioural solution."

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, 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

Continued on page 14

Asymmetric Returns: Learn to Love 'em

They're alternative investments by any other name

ALT ASSETS

BY PIERRE SAINT-LAURENT



I'm sure you remember the three Rs of asset allocation: Returns, Risk and coRelations. The problem is with that darned risk: you see, it's a symmetric concept. It means that the analyst (and the portfolio optimization software) is valuing downward movements in the assets just as highly as upward movements. And although a case can be made as to why it's the total up-and-down profile of the investment that counts (you need to keep in mind that the investment will decrease in value at times), it would be nice if we could, as investors, focus on the upside and select those assets that deliver the most of that.

There are essentially two ways we could do that: design an optimization process that focuses on the upside (or as the pros like to say, the "positive semivariance"). This turns out to not be very mainstream, and although some optimizers will claim to use third and even fourth moments (skewness and kurtosis are the more com-

mon, albeit not altogether correct terms used), semideviation optimization has never really caught on to the extent it could, or should, have. Remember, even Harry Markowitz, the father of asset allocation, mentioned in his 1952 pathbreaking paper that he was using standard deviation because he wasn't deft enough to use semivariance — of which he was fully aware.

Let's forget the path less travelled. The other way is to build investments that don't have a downside! If you control the tendency of an investment to exhibit below-average or even negative returns, you've solved one of investing's most vexing problems: you can lose money.

Therefore, asymmetric returns: lose the downside, bring on the upside. I'm a facetious guy, but someone who has devoted serious, significant thought to the matter is Alexander Ineichen. He actually wrote a book titled *Asymmetric Returns: The Future of Active Asset Management*. You want to read it, and I'll do my best to show you why.

Ineichen makes a three-pronged claim in his book: First, find investments that are lopsided on the upside (for which the potential profit is larger than the potential

loss); second, the way to achieve this goal is through active asset management; and third, active asset management's future rests in finding and accessing these asymmetric opportunities.

This view is driven by the fact that investors should prefer asymmetric returns, as more return is preferred to less, certainty is preferred over uncertainty, and losses weigh more than profits, largely for psychological reasons studied by behavioural economists.

Importantly, volatility does matter. Facing two investments with an identical capital gain, but with one much rockier than the other, an investor will choose the more sedate one, all things equal. This is obvious, but has "interim" consequences. The problem with highly volatile investments is the emotional reaction that can create double jeopardy: moving to cash just when the investment is at its lowest (thus realizing maximum losses while relinquishing the ride back up, the rebound or the reversion to mean.) Hence interim returns matter, largely because of the havoc they wreak on investor mindset. Interestingly, for Ineichen, this means a merger of the long term (the Jer-

emy Siegel *Stocks for the Long Run* view that "equities outperform bonds in the long term") and the short term ("interim volatility matters").

"... the main driver of the growth [in hedge funds] is a sustainable change in investors' perception of risk ... in other words ... short-term volatility, and therefore risk-adjusted returns, now matter to the long-term investor."

— Alexander Ineichen

To buttress his view, Ineichen demonstrates that passive investing, such as indexing, cannot dominate proper active management. The reason is simple: passive management cannot produce alpha (or benchmark-beating excess return). He makes an interesting and, in my view, valid point of distinguishing benchmark tracking and absolute-return-driven active management (Ineichen's previous book is titled *Absolute Returns*). Alpha is thus tantamount to applying an active view to generating asymmetric returns (a refinement of absolute returns, typically focused on "not losing money," asymmetric returns take it a step further in focusing on producing low-downside-risk returns).

Much of the second half of the book is about alternative in-

vestments. However, this is clever exposition, since alts are the tools to deliver the asymmetric returns studied earlier. That's why the author will take pains in outlining the positive skewness and kurtosis properties of hedge funds and discusses risk and transparency at some length.

Finally, Ineichen develops the idea of asymmetric returns management as a business, based on controlling the random (changing risk from symmetric to asymmetric) and finding alpha, which is hard to extract (it requires inordinate skill), relatively scarce and expensive to access (talent and method are expensive).

I think one of the most important contributions of this book is to add a stone to the rapidly growing edifice of risk management, or more precisely, what active managers do is to manage risk, and the returns become a logical consequence of this active risk management process. We have all learned that risk and return are the two sides of the investment coin. However, there is increasing realization, and adoption, of the idea that risk management is truly the driving force of investing.

AER

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ADVISORRESEARCH

Behaving badly **Continued from page 13**

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

And even if we assume that some alternative managers are gen-

uinely 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.

“By focusing on compensated risks, equilibrium-based investing is effective in changing clients' behaviour.”

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 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.

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.

Are subprime troubles headed for Canada?

Continued from page 2

primarily concentrated among the large banks, says Basil Kalymon, a professor of finance with the Richard Ivey School of Business at the University of Western Ontario.

“The mortgage market in Canada is really dominated by our major banks,” Kalymon says. “I think that it's generally a more conservative set of financial institutions that are operating in Canada.”

For instance, Kalymon says the majority of banks insist on mortgage insurance if it's a high-ratio

loan, greatly reducing the likelihood of defaults.

It's not unheard of for large Canadian financial institutions to get into trouble with real estate lending, though. He points to bad commercial real estate lending practices that led to the downfall of Royal Trust and Confederation Life.

“In the past we have had financial institutions failing because of real estate values,” he says. “When you do have a severe correction in the housing market, there tend to be problems

in the mortgage lending issues.”

Kalymon says there are no signals that any sort of correction is imminent, but that rising interest rates and our dependence on the U.S. housing market as a source for exports could have an impact in Canada.

“We're not totally insulated. If you have turbulence and interest starts rising fast, it's bound to have a knock-on effect. The stoppage in the [U.S.] housing market has already had lumber prices plummeting in Canada, basically because of the slow-up of construction across the border,” he says.

Not everyone thinks that sub-

prime lending is necessarily a bad thing, though. Done responsibly, Jim Murphy, president of the Canadian Association of Accredited Mortgage Professions (CAAMP), says that alternative and subprime lending serves an important role in society.

“There is no doubt that there is an alternative lending market here. It's about 5% of the market, and it is growing. It certainly meets a need – subprime or alternative lending deals with somebody's creditworthiness,” he says. “A lot of these products are helpful because they allow these people to get into home ownership. At the end of the day, this

industry is all about people wanting to live the dream of home ownership.”

Murphy says he's well aware of risks with subprime lending, but CAAMP wants its 10,000 members to develop ethical guidelines and lending practices to recognize potentially risky situations.

“Borrowers or consumers should always be mindful and select somebody they're going to feel comfortable with. They should be knowledgeable; they should be trained,” he says. “We have guidelines of what to do and what to look for in a completed mortgage application.” **AER**