

Insight: Stay the Course!

An article by Jörg Schlüter, Director of U.K. Development



Dear Investor,

Our behavior is dramatically shaped by bombardment of financial news and opinions, particularly at the beginning of each year (so called expert forecasts) and during times of financial tumult.

Inherently, we may know that we should be greedy when others are fearful and fearful when others are greedy, but we are also receiving very powerful messages and cues in the form of commentators and "experts" telling us that the "end is nigh" and when we look at our quarterly portfolio statements. If we don't have decisional constraints in place, it is easy to be lured into making wrong decisions!

Our capacities for intense focus and restraint are limited and today's moderation sows the seeds for tomorrow's excesses (ask the person on a very restricted diet, when they binge-eat at the first possible opportunity!) - that's why we need to create habits and processes. As in all areas of life: motivation is what gets you started, habit is what keeps you going!

For investing, that is even more obvious: it is extremely difficult and draining to be conservative in the face of a bullish market or to snatch up bargains during a panic. So difficult, that anybody would fail if they had to make those decisions every day (think of your struggles in deciding what to wear every day!) that, unless an investor has a process and a discipline to follow the process with exactness, he/she is prone to fail.

An analysis by various authors (*Gary, Vogel and Foulke, DIY Financial Advisor, p. 23*) found that investment models equal or beat expert decision-making a startling 94.12% of the time, meaning that human discretionary decision making was superior only 5.88% of the time. All the research corroborates the fact: if you are using human judgment instead of a process to make investment decisions, you are doing extra work with diminished results!

The solution is in designing and abiding by an investment process that is as much as possible resistant to behavioral decision-making errors. (Consider this: with all the knowledge that you have, you should never lose your temper with your kids, skip exercise or overeat, if emotions had no overriding effect. Education is no substitute for emotional guardrails).

Costs, of course, also play a major role in achieving investment returns. Consider this example: an investor saves GBP 500 per month and subsequently invests GBP 6'000 once per year at an annual return of 6% over a 35-year period.

With NO fees (which, admittedly, is unrealistic but used here for comparison purposes) the investor's portfolio has grown to GBP 670'000. At an annual fee of 1% and 2%, this amount is reduced to GBP 540'000 and 440'000 respectively - that's a GBP 230'000 reduction in net return at 2%! The message here is unequivocal: the lower the fees, the better!

When looking at financial markets and the stock market in particular, we generally have to deal with three types of risk: systemic, unsystematic and behavioral.

Systemic risk refers to market risk, i.e. losing money from broad market moves. This risk cannot be diversified away and examples include natural disaster, acts of terrorism, etc.

Unsystematic risk refers to the individual business risk and reflects the risks of an individual business going down in value. This risk can and should be hedged against through diversification, i.e. owning more than one company from more than one business sector.

Behavioral risk refers to the fact that your own actions increase the probability of “permanent loss of capital”.

In brief, therefore, **systematic risk** means the failure of markets, **unsystematic risk** the failure of business and **behavioral risk** means the failure of self. Of these, we can control the last two, unsystematic risk and particularly behavioral risk which, in my humble opinion represents the single biggest reason why most investors (private as well as institutional) fail in making great returns over time.

As the behavioral risk is so important, this week’s insight goes into more detail here. According to Dr. David Crosby (*"The Laws of Wealth"*, p. 135), behavioral risk can be split into 5 categories:

- **1. Ego:** overconfidence and the defending of own decisions. It manifests itself in overly concentrated portfolios and/or excessive leverage.
- **2. Information:** the investor is unaware of her own bias and often has a preference for known risks over unknown risks. He/she is often slow to adopt new information when it arises. Even though generally the future looks the same as the past.
- **3. Emotion:** the perception of risk is influenced by our shifting emotional state and our individual tendency towards positivity or negativity. This is why generally the financial advisors risk profiling tools do not work very well, as investors give different answers at different times, depending on their emotional state at the time of answering the questionnaire.
- **4. Attention risk:** this risk reflects our tendency to give more weight to "low-probability-high scariness " risks like being in a terrorist attack, while ignoring "high-probability-low-scariness": risks, such as eating at McDonalds (the fact that you do not immediately drop down with a heart attack does not distract from the long-term danger of eating highly processed foods!).
It also includes the tendency to rate the "unfamiliar" as riskier and give preference to "familiar" names, regardless of fundamental qualities.

- **5. Conservation risk:** this reflects the fact that we have a tendency to have asymmetrical preference for gain, relative to loss and we tend to prefer the status quo relative to change. We prefer winning to losing and the "old way" to the "new way".

It is often evidenced by selling “winners” too early and holding on to “losers” for too long.

Based on all of the above, investment strategies *that work* tend to be low fee, diversified, low turnover *and* taking into account behavioral biases.

The reliable way to combat behavioral risk is to “create a simple process that accounts for each behavioral risk” and to follow that process unflinchingly!

This requires a process orientation instead of a goal’s orientation. Therefore, you should set out your investment process with all the required parameters and then follow it, independent of the behavior of the general market.

Let's look at a simple, but effective example, by looking at the Lapis Top 25 Dividend Yield Fund (*acknowledgement: the author is personally invested in the fund and has a personal interest in it. It is used here for information purposes only and does not constitute a solicitation to buy or sell the investment! Investors are urged to do their own due diligence and/or seek professional advice, before making any investments*).

The Lapis fund is rules based and thereby excludes subjective behavior. It invests in **25 global companies**, that are equal weight in the fund. Each company has a minimum **USD 25bn market capitalization** and a minimum of **25 years of uninterrupted and continuously increasing dividend payments**. The annual management fee for the fund is 0.45%.

The selection criteria of all eligible companies (about 150) to get to 25 is undertaken as follows:

- 50% weight is given to the dividend yield;
- 25% weight is given to the market capitalization of the company;
- 25% weight is given to the compound annual growth (CAGR) of the dividend of the company over the 25-year period.

The fund is then rebalanced every quarter.

These are fairly simple rules and there are other funds and ETFs (Exchange Traded Funds) which have more complex rules, but also aim to eliminate behavioral biases.

Let’s remind ourselves of the requirements for a working investment process and how the Lapis fund fits the criteria: investment strategies *that work* tend to be low fee, diversified, low turnover **AND** taking into account behavioral biases.

- **Low fee:** the fund charges an annual management fee of 0.45%, with an additional cost of 0.30%, for a total of 0.75%. While a lot of ETFs are still cheaper, as an actively managed fund, the Lapis fund falls into the lower cost funds and therefore fulfills criterium number one.
- **Diversified:** The Lapis fund invests globally and includes companies from the US, Japan, Canada, Switzerland, UK and EU. It also represents companies from various different sectors of the industry, such as Oil, Pharma, Insurance, Banking, Consumer Staples, Telecoms, etc. It therefore can be classed as well diversified (but not over-diversified, a topic for one of the next blogs).
- **Low turnover:** based on the three inclusion criteria (Div. yield, mkt. cap, CAGR of div.) there are few changes every quarter. Over the last two years, quarterly changes were one or two companies per quarter. The quarterly rebalancing to 4% weighting in the fund for each company leads to some "activity" with regards to turnover, but is easily offset by the gains made from the inherent system of "buy low - sell high", as stocks that have advanced during the quarter get pared back to 4% weight (taking profits = selling high), while those that have lagged will be added to (buying low).
- **Behavioral biases:** the application of the funds rules is strict, which means that after the criteria and rules are set based on human research, there is no further human pondering necessary and therefore it is not prone to any behavioral biases!

Again, this is just one example, but one that works and shows that simple rules-based investing can beat both the general market as well as funds where the fund manager is prone to behavioral fallacies.

As an investor you are therefore well advised to either scour the market for rules-based funds and ETFs or set your own set of rules and Stay the Course! In the long run, this will lead to superior returns as well as let you sleep well at night.

Best regards,

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