



9th December 2013

The emotional investor

“To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What’s needed is a sound intellectual framework for making decisions **and the ability to keep emotions from corroding that framework.**” [Emphasis ours.]

- Warren Buffett in the preface to the fourth edition of Ben Graham’s ‘The Intelligent Investor’.

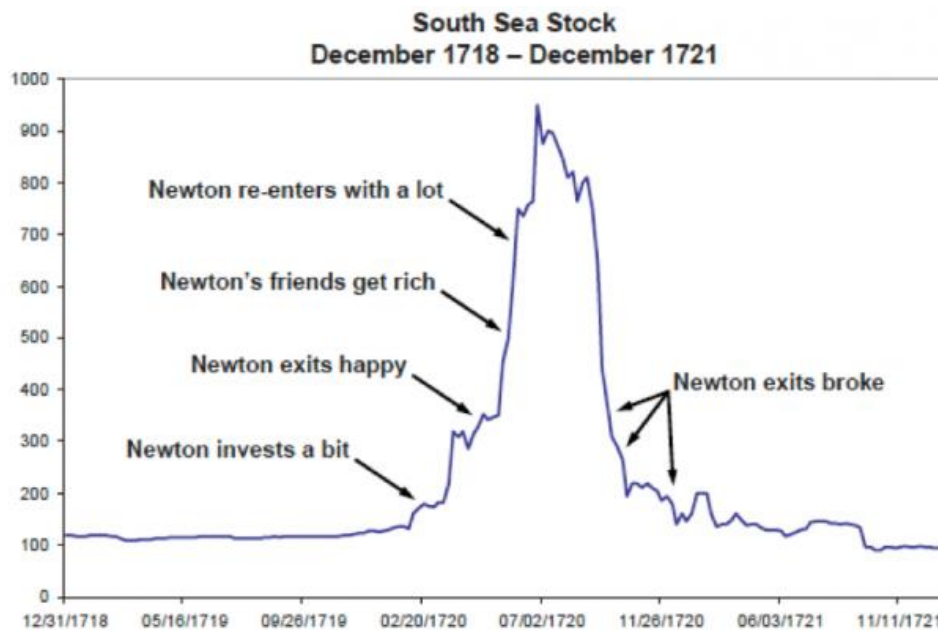
“If you have formed a conclusion from the facts and if you know your judgment is sound, act on it – even though others may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right because your data and your reasoning are right. Similarly, **in the world of securities, courage becomes the supreme virtue** after adequate knowledge and a tested judgment are at hand.” [Emphasis ours.]

- Ben Graham, ‘The Intelligent Investor’. Again.

For practitioners of Schadenfreude, seeing high-profile investors losing their shirts is always amusing. But for the true connoisseur, the finest expression of the art comes when a high-profile investor identifies a bubble, perhaps even makes money out of it, exits in time – and then gets sucked back in only to lose everything in the resultant bust. An early, and fine, example is the case of Sir Isaac Newton. As any fule kno, the South Sea Company was established in the early 18th Century and granted a monopoly on trade in the South Seas in exchange for assuming England’s war debt. Investors warmed to the appeal of this monopoly and the company’s shares began their rise. Although its management team was inexperienced, they were not inexperienced enough to prevent further shares being issued to a frenzied public developing a taste for rapid returns. Britain’s most celebrated scientist was not immune to the monetary charms of the South Sea Company, and in early 1720 he profited handsomely from his stake. Having cashed in his chips, he then watched with some perturbation as stock in the company continued to rise. In the words of Lord Overstone, no warning on earth can save people determined to grow suddenly rich. Newton went on to repurchase a good deal more South Sea Company shares at more than three times the price of his original stake, and then proceeded to lose £20,000 (which, in 1720, amounted to almost all his life savings). This prompted him to add, allegedly, that

“I can calculate the movement of stars, but not the madness of men.”

The chart of the South Sea Company's stock price, and effectively of Newton's emotional journey from greed to satisfaction and then from envy and more greed, ending in despair, is shown below.



Source(s): Marc Faber, Jeremy Grantham, Sir Isaac Newton

A more recent example would be that of the highly successful fund manager Stanley Druckenmiller who, whilst working for George Soros in 1999, maintained a significant short position in internet stocks that he (rightly) considered massively overvalued. But as Nasdaq continued to soar into the wide blue yonder, in a manner not altogether dissimilar to that of South Sea Company shares, he proceeded to cover those shorts and subsequently went long the technology market. Although this trade ended quickly, it did not end well. As David McCreadie of Monument Securities points out, three quarters of the internet stocks that Druckenmiller had originally shorted (and which he subsequently bought back) eventually went to zero. The remainder fell between 90% and 99%.

And now we have another convert to the bull cause. Fund manager Hugh Hendry has hardly nurtured the image of a shy retiring violet during the course of his career to date, so his recent volte-face on markets garnered a fair degree of attention. In his December letter to investors he wrote the following:

“This is what I fear most today: being bearish and so continuing to not make any money even as the monetary authorities shower us with the ill thought-out generosity of their stance and markets melt up. Our resistance of Fed generosity has been pretty costly for all of us so far. To keep resisting could end up being unforgivably costly.”

Hendry sums up his new acceptance of risk in six words:

“Just be long. Pretty much anything.”

Will Hendry's surrender to monetary forces equate to Newton's re-entry into South Sea shares or Druckenmiller's dotcom capitulation in the face of crowd hysteria? Time, as ever, will tell. In the meantime, call us old-fashioned, but rather than submit to buying “pretty much anything”, we're able to square the circle of investing rationally in a QE-maniac world by sailing close to the Ben Graham shoreline. Firstly, we're investors and not speculators. (As Shakespeare's Polonius

counselled: “To thine own self be true”.) Secondly, our portfolio returns aren’t exclusively linked to the last available price on some stock exchange; we invest across credit instruments; equity instruments; uncorrelated funds, and real assets, so we have no great dependence on equity markets alone. Where we do choose to invest in stocks (as opposed to feel compelled to chase them higher), we only see advantage in favouring the ownership of businesses that offer compelling valuations to prospective investors (Graham referred to this as a ‘margin of safety’) – or in locating managers capable of identifying such businesses.

In Buffett’s words, we spend a lot of time second-guessing what we hope is a sound intellectual framework. Examples:

- In a world drowning in debt, if you must own bonds, own bonds issued by entities that can afford to pay you back;
- In a deleveraging world, favour the currencies of creditor countries over debtors;
- In a world beset by QE, if you must own equities, own equities supported by vast secular tailwinds and compelling valuations (for more on this, see [this piece](#));
- Given the enormous macro uncertainties and entirely justifiable concerns about potential bubbles, diversify more broadly at an asset class level than simply across equity and bond investments; given the danger of central bank money-printing seemingly without limit, currency / inflation insurance should be a component of any balanced portfolio (even if deflation in western economies may be the more plausible immediate threat, as Russell Napier suggests, do we honestly think it won’t be met by even more aggressive monetary stimulus from the brain donors at the central banks ?);
- Forget conventional benchmarks. Bond indices encourage investors to over-own the most heavily indebted (and therefore objectively least creditworthy) borrowers. Equity benchmarks tend to push investors into owning yesterday’s winners – at the high price that their popularity ensures.

The ‘wild card’ in all this is one Buffett also alluded to – “the ability to keep emotions from corroding that framework”. It is worth labouring the point that human emotions evolved on the savannah, not in the dealing room. As fund manager Chris Clarke points out, fear and the likes of the fight / flight mechanism were the human evolutionary response to threats like sabre-toothed tigers. Humans have been running to and away from four-legged food sources (and sharp-fanged threats) for hundreds of thousands of years. Financial markets and the to and fro of securities price action have been with us for a few hundred years at most – we have not yet developed any evolutionary response, so the brain’s reaction to losing money on an investment that might yet come good is often crude and counter-productive. In the words of Sir John Templeton,

“To buy when others are despondently selling and sell when others are greedily buying requires the greatest fortitude and pays the greatest reward.”

And in the words of John Maynard Keynes,

“It is the long-term investor, he who most promotes the public interest, who will in practice come in for the most criticism.. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion.”

So be long “pretty much everything”, or be long a considered array of carefully assessed and diverse instruments of value. It’s a fairly straightforward choice.

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