PRICE VALUE PARTNERS

Telling tales about the markets

"Ever since the markets blew up in 2008 many investment practitioners have been engaged in something akin to a whodunit. Just how did we get into this mess ? This book is an answer, of sorts. ***Everybody did it***. We all played a part.

"As Lord Overstone once remarked, no warning can save people determined to grow suddenly rich. In the run-up to the Global Financial Crisis accident-prone bankers were only doing what they always do: gambling, badly, it transpired, with other people's money. There was no shortage of irrational behaviour by property speculators, or homeowners, as they are sometimes called.

"But the rot in the system runs deep. After the collapse of Lehman Brothers in September 2008 most banks did not fail, because the central bankers of the world did not allow them to. Be careful what you wish for. The financial markets are now in thrall to these unelected monetary technocrats. The extraordinary monetary policies that central bankers are now pursuing are destabilising financial markets and suppressing their natural price signals."

- From the Introduction to *Investing through the Looking Glass: a rational guide to irrational financial markets*.

If you wanted to design an environment for investing that was most maddening for the greatest number of people, the chances are that you couldn't improve on the state of modern technology and financial media as at early 2018. Buy and sell and switch between stocks and funds effortlessly online at negligible cost. Monitor the prices of those stocks and funds online in real time. Immerse yourself in a news environment online in which limitless commentary masterfully confects a heightened emotional response to what would otherwise pass as noise. Lather, rinse, repeat. And then wonder why your commitment to investing for the long term never quite survives first contact with the enemy.

The structure of the collective ownership of equities matters. We have no problem with investment vehicles incorporating low fees. But we suspect that index ownership combined with low fees will come with unintended consequences for many buyers of ETFs. Investors who buy actively managed funds – with their higher inherent fees – will tend to trade those funds less actively than investors encouraged by the lower fee burden that mentally transforms lower cost funds into something akin to listed shares. Holders of active funds are, or at least ought to be, to all intents and purposes more inclined to view the world like Warren Buffett's 'punch-card' investors, who have conditioned themselves to take the long view and who are more likely to be discerning between relative valuations. They are also less likely to overtrade.

ETF "investors", on the other hand, are more likely, literally or figuratively, to become traders. As and when the stock market (i.e. the US stock market, as that's the one we're ***all*** really worried about) turns conclusively down, ETF "investors" are, we suspect, far more likely to hit the panic button far more quickly. (Let's put to one side the fact that ETFs are, by definition, undiscriminating, so their ideal users are "investors" who positively ***insist*** on getting nothing more than the average return.) In other words, there is roughly $5 trillion by way of assets under the control of hair-trigger traders.

But as we have suggested, the media environment is not conducive to a long term perspective. The Zurich-based investor Tony Deden has written nicely of the emotional spiral that can come to afflict those being tossed and turned on the vagaries of the financial news cycle:

> Daily, my mail box is full of emails, many of which come from well-meaning friends. "Have you seen this article ?" or "Do you know this guru ?" I follow the links as I frantically go from thenewyorktimes.com to financialarmageddon.com and everywhere in between. "The dollar will rebound", "Gold is another bubble", "Buy bonds", "Sell bonds", "Pork bellies are undervalued," and so on. I pretend to read some of these writings just so that I can make up something to say should they follow up the email with a telephone call. In an enduring quest for understanding and picking kernels of knowledge, I find myself surrounded in an epochal – and mad – battle of the optimists versus the pessimists.
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> Honestly, there are intractable and momentous problems which should be the cause of considerable pessimism. But when it comes to action with other people's money – particularly the irreplaceable kind – merely on account of the free advice of a well-known guru who writes for the-world-is-coming-to-an-end.com is complete madness. To follow the advice of an analyst working for a bank that can't even manage its own balance sheet and who is intentionally or accidentally divorced from reality, is madness squared.

Morgan Housel has also asked Why we listen to bad forecasts. Why do people believe far-fetched forecasts with no track record of accuracy ?

> The correlation between high stakes and people's willingness to believe quackery is high. And it's pretty rational.
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> A low-probability, high-stakes prediction should always be taken seriously. And if your world is so confusing that you can't determine probabilities, defaulting to assume that prediction will come true may increase your chances of survival.
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> When things are calm people believe what they tell themselves. When things are crazy they believe what other people tell them..
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> Brent Beshore has a great philosophy: "In the moment, people act rationally, always," he says. "The question is what information, preferences, time horizon, and biases came into play?" High stakes and uncertainty is a huge information asymmetry that causes rational people to pay attention to crazy forecasts.

The invariably excellent Farnam Street blog also offers some useful strategies to avoid succumbing to the narrative fallacy.

We would offer the following additional advice:

- If the stakes appear high, reduce them.
- Reduce your exposure to fanciful narratives by restricting your news network to the smallest number of genuinely trustworthy and ideally independent sources.
- Reduce your exposure to risk through the simple mechanism of basic mathematics.
- Reduce your exposure to expensive assets – not least, almost all bonds – in favour of cheaper ones.
- The prices of highly valued stocks (for example) have far greater potential to fall than those of more lowly valued stocks.
- The prices of popular stocks have far greater potential to fall than those of stocks that nobody ever owned to begin with.
- Move the odds further in your favour by consciously aligning yourself with managers (either of funds, or of meaningfully diversified companies – the difference is largely moot) displaying a healthy commitment to maximising shareholder returns and an unusually high ability to allocate capital efficiently. While Warren Buffett is regarded as the *nonpareil*, he has good company with the likes of the Tisch family of Loews Corp, the Desmarais family of Power Corp, the Bresky family of Seaboard Corp..

And if overmuch consumption of digital media is the primary problem, then there is a handy three word solution. Turn. It. Off.

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Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here.