GRAY MATTERS

Information overload can undermine your returns

1 February 2014
Issue no.8

'Most of the time stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble ... to give way to hope, fear and greed.' *- Benjamin Graham*

Modern society has become addicted to information, particularly when it comes to investing. Everyone focuses on the huge volume of short-term news and daily prices. The fastest growing form of communication (twitter) is a medium that limits a message length to 140 characters. Does this frequency and amount of information make us better investors? Unfortunately not. It appears that investors continue to sell on bad news and buy on good news. Fear and greed still drive many investment decisions.

The gap in returns caused by investor behaviour

The US-based Dalbar Study highlights how investors' behaviour affects their returns. What they refer to as an 'investor behaviour gap' represents the difference between the return of the market and the actual return received by investors, taking into account their decisions on when to buy and sell. The gap is substantial. Their research suggests that investors tend to buy at a high price when they feel confident, and sell at a low price when they become fearful. By doing this, investors reduce their long-term returns – as shown in the table below.

	Average Equity Investor return	S&P 500 Index return
20-year returns (for period ending 31 December 2012)	4.25% p.a.	8.21% p.a.

Source: 2013 QAIB – Advisor Edition, April 2013, Dalbar Inc.

Short term 'noise' is part of the problem

One key reason for the behaviour gap is investors' inability to filter the noise in the market. During events such as the GFC, terrorist attacks, change of governments and natural disasters, we are inundated with 'noise' by newspapers, magazines, TV and so-called experts. Investors often respond with emotion before logic, and overreact. This applies to both excessive optimism and pessimism. Investors are lured into buying or selling assets without considering their true value. In this way they overpay for a rosy outlook, and capitulate when expectations appear poor (but prices are cheap). This is the surest way to lose capital.

What can you do to shut out the noise?

So how do you maintain a cool head and shut out the noise? How do you know when to listen? It is not easy. Short-term extremes in sentiment are part of human nature. One way to remain calm and make better decisions is to have a solid reference point. This entails having a set plan with investment objectives and goals. A financial adviser can help you develop this in the form of a personal financial plan. This will help you invest wisely and stand a better chance of achieving your long-term goals.

Investors should therefore focus on what they can control, such as ensuring they have a financial plan, choosing a good financial adviser and listening to their professional advice about their investment decisions. Investors should also avoid the lure of last year's best performing investment theme. By the time a new fad or theme becomes an investment product, it is often overpriced and the opportunity is therefore gone. Some more practical ways to manage your response to short-term noise are below:

- The media, and particularly commercial outlets, are paid to fill pages and news bulletins with sensational stories, so from an investment point of view, it is best to take their news with a grain of salt.
- Leading experts and economists are also paid to develop narratives about the current situation. It is okay to listen to these, but it is equally important to understand their motivations, their limitations, how quickly the narrative changes and how often they have in the past been proved wrong.
- For any piece of news, ask yourself whether it is fact or opinion. If it is fact, remember that when you hear it, it is probably common knowledge and already 'in the price'. If it is opinion, consider the motivations and biases of the information provider.
- Do the work. This means form a set of beliefs and principles about your personal finances. A financial adviser can help you do this by developing a foundation for your beliefs. This will help you to avoid being influenced by others. If you do already have a financial adviser, ask them how they avoid overreacting to short term noise themselves – they may have some good tips.
- Remember your goals, be patient and think long term.

How we reduce the noise – we take a long-term approach

As fundamental valuation-based investors know, it can take time for the market to revalue an undervalued share. This is why we share Warren Buffett's sentiment that one should 'Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years.'

We don't follow the latest trends or invest on a whim based on short-term and popular 'conclusions'. This behaviour magnifies the risk of overpaying for something that is popular. We take a thorough and disciplined approach to understanding the intrinsic value of each business that we analyse. We prefer to consider unpopular shares that are available at a lower price because others have overreacted to short-term negative news. This means that our portfolios are often very different to those of our peers. We only invest when we are sure that we have a 'margin of safety' or inherent measure of protection built into our valuations.

Simon Mawhinney, Portfolio Manager for Allan Gray says it best. 'I think it is impossible to shut out the noise. However, all that is required is to be less influenced by the noise and take a very long-term view of things!'

Commentary by Marietta Gibbs, Relationship Manager at Allan Gray Australia