



WEALTH
 WEEKEND EDITION | Edited by Andrew Main

Investing in human nature

Some people are so busy looking at recent trends that they lose long-term perspective

GILLIAN BULLOCK

INVESTING is more about psychology than it is about economics. Or maybe there's just a blending of the two, given the old joke about putting 10 economists in a room and ending up with 11 opinions.

But there are some words of wisdom that come out of the mouths of economists that have stood the test of time and can probably help investors work through these volatile times.

Andrew Pease, chief investment strategist at Russell Investments, says this realisation about the role of psychology in investment tends to develop the longer you are in the business.

"When you start out a lot of learning about investments is technical knowledge but as you progress you realise it's more about behavioural factors and how to avoid behavioural potholes," he says.

He cites a number of potholes, including the recency effect and the confirmation bias.

With the recency effect — a term associated with Nobel Economics Prize winner Daniel Kahneman — you are heavily influenced in making an invest-

ment decision by what is happening now rather than something that may have happened four or five years ago, and as a result you forget the long-term lessons.

Another issue is the confirmation bias.

This is where once you have, say, decided to go overweight in the Aussie dollar or sell equities, you then tend to gravitate to the information that supports and confirms this view, while avoiding contrary views.

Both these factors can contribute to your making the wrong calls and underline why it is important to have good governance and structure when making investment decisions.

And while Russell Investments follows strict governance and structure, Pease makes the point that most decisions are made by committees and this too can create a pothole.

For instance, there is a fine line between harnessing the wisdom of the crowd and falling into the trap of group thinking.

Although it is a pothole he believes Russell Investments navigates around well.

Timing in the market is an almost impossible task, highlighted in the words of economist Rudiger Dornbusch. He said: "In economics, things take longer to happen than you think they will and then they happen faster than you thought they could."

Because of this phenomenon, investors tend to get impatient

waiting for things to happen but then when it reaches a tipping point they are then surprised.

The behaviour of sharemarkets is also hard to pick.

In the words of economist John Maynard Keynes: The market can stay irrational for far longer than you or I can remain solvent.

Pease says you have to have patience in the market and go with the flow. "The longer I am in the industry, the less confident I am about having particular views," he says.

"The great investors are those who are less dogmatic and don't make grand predictions."

Or in the words of Keynes: "When the facts change, I change my mind."

And that is the modus operandi for Russell Investments, which uses strategic tilting when an asset class moves so far away from its equilibrium of long-term average valuation that its valuation is classified as extreme.

But this only works effectively when done in a risk-controlled manner using robust processes and with strong governance.

"It is essential that any investment organisation contemplating strategic tilting has a strong governance structure which enables committed, accountable and clear decision-making at all times," says Pease.

Strategic tilting is a world away from tactical asset allocation, which is more based on a

'You realise it's more about behavioural factors and how to avoid behavioural potholes'

'The great investors are those who are less dogmatic'

ANDREW PEASE
 RUSSELL INVESTMENTS



short-term strategy. "Back in the 1980s most flagship funds used tactical asset allocation but in the 1990s we saw a shift to remaining at a fixed strategic asset allocation," says Pease.

Russell Investments only implements strategic tilting in an asset when it has a high level of confidence and conviction that markets are at an unsustainable or extreme level.

"With strategic tilting, investment decisions are only made when they pass a set of clearly defined rigorous decision-making hurdles.

A good example was in June 2008 when the Aussie dollar was 40 per cent above its equilibrium, real interest rate differentials were at record highs and momentum filters such as commodity prices were turning negative.

"At \$A0.95, our tilting process suggested a short \$A/\$US position," says Pease.

"After six months we closed the position after the currency declined 30 per cent to below purchasing power parity and our conviction on other filters waned."

While everybody wants to be a timing winner, in reality only 5 per cent of total risk and return for a portfolio should come from market timing.

Rather, strategic asset allocation will make up 85 per cent of total return while ability of the right fund manager to outperform benchmarks takes up the balance.