

intelligent investing



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Graham Bentley explains why advisers should avoid market 'noise' – and suggests what you need to know to achieve a superior level of investment advice.

Warren Buffett once said that 'risk comes from not knowing what you are doing'. My own version would add '...or why you are doing it'. Simply knowing 'if this happens, the received wisdom is to do this' is not enough - why you should do it is most important. What was wisdom 30 years ago may now be nonsense. The problem is not simply what you do not know, but also what you do know. Many advisers make costly investment mistakes because what they know is in fact a fiction, learned from similarly misinformed but respected sources.

The great Ben Graham wrote the standard text on securities analysis in the 1930s. It is still probably the most widely read textbook on stock selection

techniques, and the 'Bible' as far as many fund managers are concerned. What many of its readers may have missed is the fact that in 1976 Graham recanted his beliefs in the Financial Analysts Journal:

'I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities... this was a rewarding activity, say, 40 years ago...but (today) the situation has changed...I'm on the side of the 'efficient market' school of thought.'

When I look back at what I was taught when I first came into the industry 30 years ago, I can only smile at the so-called investment rules that have since proved to be nothing more than their own untested opinions and intuition. >>

>> avoiding 'noise'

Think about how you currently make investment decisions. What is your biggest problem when making those decisions? Not enough information? Not receiving information fast enough? I think there is too much irrelevant information.

Around the world financial research and marketing departments abound, millions of charts are drawn, thousands of reports are written, and fund manager opinions proliferate at an increasing rate. How are we supposed to use all this stuff? Think about that word 'information'. Information is any material which contributes to the formulation of decisions which 'add value'². The raw materials of information are facts, data and news. Trillions of bits of transaction data are generated on the world's markets and their economies. All of these are counted and measured in

some form. This is not information. You need knowledge to translate data or news into information whereby value-added decisions are made. The ticker on a website tells you that the FTSE 100™ is up 15 points. This is news, but it is not information. This is meaningless data, otherwise known as 'noise'.

Noise arrives in two ways. Most often we do not know how to filter and translate the mountains of news we are bombarded with into information which adds value. Less often, but more damaging, is our inability to spot bad data. No amount of knowledge can turn bad data into a value-added decision.

In 1986, Fischer Black (the co-discoverer of the Black-Scholes options-pricing model) wrote a landmark paper on the subject in the Journal of Finance. He was the first to make the distinction between noise and information. He labelled people who

trade securities on the basis of incoming streams of data (which are unlikely to be precursors of future prices) 'noise traders'. He said, 'One trader's beliefs are as good as any other trader's beliefs'; in other words they are all useless³. Facts and data are descriptive measures of something that has occurred. News is new facts or data. Knowledge is required to turn facts and data (new or old) into useful information which adds value to the decision-making process. It has been argued that the barrage of data we are subjected to is designed to urge us to act quickly and frequently.

intelligent, not instinctive

Do you read the financial pages every day? Do you avidly digest rumours, speculation on interest rates and market outlooks? The more you attempt to keep up and be aware of everything that

do you trust your intuition?

Add these numbers in your head.
Start with 1,000. Add 40. Now add another 1,000.
Add 30. Add another 1,000. Now add 20. Add
another 1,000. Add 10.

If you answered 5,000, you will be delighted to learn you are in the majority... who got it wrong. The correct total is 4,100. Our brains often have difficulty with even the simplest stream of information – we arrive at a result intuitively, but it feels like we have 'worked it out'.

Superior investment advice applies knowledge logically and in a disciplined fashion, avoiding the mistakes we make when we rely on intuition.

is going on, the more susceptible you are to basing your investment decisions on noise. If you have invested intelligently, today's news will have little impact on your portfolio performance.

Intelligent investing involves understanding investment theory and applying that knowledge logically and in a disciplined fashion, thereby avoiding the mistakes we make when we rely on intuition.

The investment decision-making process is complex, but it need not be difficult. Advisers need to use technology that provides investment discipline, provided by organisations with an understanding of current investment theory and psychology. Thus they can give the client the highest level of professional investment advice and eliminate unnecessary and potentially costly mistakes from the advice process. ■

Sources:

¹ Benjamin Graham, *Financial Analysts Journal*, vol.32, no.5 (September-October 1976)

² C Mader & R Hagin, *Information Systems: Technology, Economics and Applications Science Research Associates, Inc* (1974)

³ Fischer Black, 'Noise', *Journal of Finance*, vol.41, no.3 (July 1986)

a curious incident

Even 'experts' can be misled by intuition. Anyone who has read Mark Haddon's excellent book *The Curious Incident of the Dog in the Night-time* will have been introduced to what has become known as the 'Monty Hall Problem', named after a 1960s US game show host.

Essentially, the problem is about decision-making under uncertainty, and is based on a game where a contestant is presented with three closed doors. Behind one of the doors is a car, but behind each of the other two doors is a booby prize. The contestant picks a door, but does not open it. The host then opens a door the contestant did not pick, to show a booby prize. He then offers the contestant a final chance to switch to another door or stick with the one they chose, before opening the doors to reveal either the car or the booby prize. Should you stick with the door you picked or change your mind?

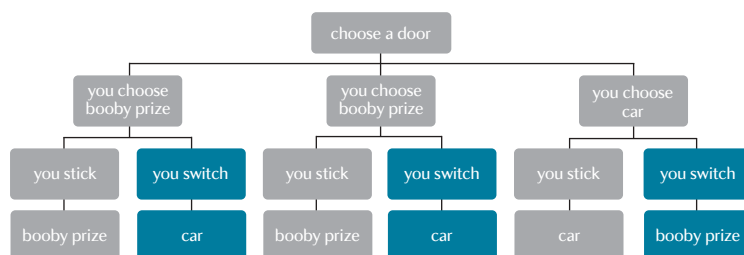
Intuitively, you might say that it should not matter - surely the odds are even because there is an equal chance that the car is behind either of the remaining two doors. When Marilyn Vos Savant (who has the

world's highest IQ) was asked this question in a magazine, she told readers they should always switch, because you would have two chances in three of winning the car. Her answer caused a furore among maths teachers and university professors, who in large numbers demanded she admit her mistake - it should make no difference. Despite showing a mathematical proof, she was further challenged by the establishment.

Curiously, a simple chart (below) showing all the possible outcomes demonstrates that she was correct, yet today there are websites abounding testing this, asking you to play the game and add your result to the thousands of other tests, perhaps hoping to eventually prove the even bet is correct.

This demonstrates that even though we can receive a simple set of facts (doors, car, booby prizes) and valuable information (one door has a booby prize behind it), the way we analyse that information to make a value-added decision can lead us astray without the appropriate knowledge (eg the ability to work out probabilities).

stick or switch?



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