for financial advisers only

keeping the faith

September 2009

Graham Bentley explains why investing is a little like supporting England during the Ashes – and why investors should be careful not to adopt the same psychology.

Sport is a wonderful thing, particularly where spectator psychology is concerned. Cricket fans' past experience of the English team, and its ability to confound supporters, was never more starkly illustrated than the final Test at the Oval this year. Just when you thought all was lost (Headingley, game over inside three days), and Australia odds-on to take the series, along came Saturday 22 August. England found themselves in a dominant position, leaving Australia to chase a total of 546 to win. I was astonished to find the odds on Australia winning were 28-1 against. In other words, the bookies implied that if our antipodean cousins had 29 attempts at that total, they'd actually manage it once. Astonishingly, the odds actually narrowed at the end of the third day, despite Australia still needing another 466 to win. England's odds were amazingly good; 5-1 on, in other words a one-in-6 chance they would not win. There was a clear nagging feeling amongst many England supporters that if anything could go wrong it probably would, we were bound to throw it away, and that a pretty average Australian team can achieve a miracle – to get the runs or bat for two and a half days for a draw.

Why would it be such a marvellous achievement? In over 50,000 first-class matches on this planet (Wisden has yet to go extra-terrestrial) that total of 546 has only been achieved in a fourth innings on four occasions (ie four out of 50,000, or 49,996-1 against, and one of those was match drawn after 10, yes 10 days), and never as a winning total. Despite all of the statistics, many supporters dared not believe England would win easily – they had an unjustifiably pessimistic view based on the most recent experience (Headingley), thus ignoring historical evidence that strongly pointed to an England win, while overestimating the ability of Australia based on a 'brand' that stood for sporting excellence. This has parallels with investors' views of stock markets, but I'll come back to that.

unknown unknowns

Aside from cricket, Australia is mainly famous for Nicole Kidman and marsupials, but rather less so for a peculiar species of swan, *Cygnus Atratus*. In Europe, if we see a swan it will be white. It is easy to see how we might conjecture that all swans are white. We can't observe all swans in the world to verify that they are all white, but over time the weight of evidence leads us to state with certainty that all swans are, in fact, white.

Students of philosophy will know that such a statement is testable because it is *falsifiable*; if we find a single black swan, then the statement all swans are white would be falsified by the counter-example of the single black swan. The 18th century discovery of the black swan in Western Australia instantly changed a long standing assumption that had ultimately been understood to be fact. Many readers will now recognise the 'black swan' as a metaphor for 'outliers', single events that fundamentally change our world view because they a) falsify previous thinking, and/or b) are events of such magnitude that they are not predictable by reference to the past, and as a consequence change the course of history – Donald Rumsfeld's 'unknown unknowns'. This image has resonance in investment markets, notably through Nassim Nicholas Taleb's book 'The Black Swan — The Impact of the Highly Improbable', which points out the propensity for human beings (and investment bankers) to be overconfident, and urges investment professionals to admit the apparent frailty of their knowledge. The underlying principle of the book is that overconfident forecasts based on past occurrences can lead to surprises – past performance is no guide to the future and all that. Australia getting 546 runs in the fourth innings to win would have been such an extreme outlier, a 'black swan' if you will. However, betting against it happening made sense, *as long as you could tolerate the consequence of losing* if the extreme event actually came to pass. In other words, don't ever 'bet the farm' on a cert because there's no such thing. Which brings me to stock markets (see, we got there eventually). The events of September/October 2008, where the world appeared to be on the brink of collapse, were being described as a black swan; one-year returns on UK Equities were down 43%*. However, those returns were not extreme outliers. Equity returns did not fall outside the 3-sigma boundary – they

were within a 98.5% confidence level. If you stuck to your plan, you didn't suffer that loss anyway; as I write this the FTSE® All Share has risen by over 40% since March this year (handy for annual ISA investors!). There are of course other places to invest than equities. You may recall my allegory in last month's informer, relating the tale of Mr Market. Well Mr Market has been alive and screaming in corporate bond markets too, as his depressive state forced prices down and yields sky high. Since March the average Sterling High Yield fund is up 33%*, while investment grade is up some 14%*. These rises *are* outliers, a direct corollary of ultra low prices at the end of last year.

consistent delivery

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We have consistently reminded our readers throughout the last nine months of the potential returns available given markets were at their depressed levels. Despite this there will be some advisers who remain reticent about investing, or worse regretful that they missed the recent rally. Let me avail you of that prevailing psychology. It is not unlike that of our aforementioned cricket fans; in Q4 2008 investors were like England supporters after Headingley, gloom-laden and dismal, refusing to believe there was any way back. We had capitulated to such an extent we were unwilling to invest in deposit accounts, preferring to keep the money at home; the equivalent of turning to a former dance champion in an attempt to turn the Fifth Test into a five-day edition of 'Strictly Come Batting'. Even after a useful first innings at the Oval, many were sure England would be quickly overtaken. The second day's poor showing by Australia was a fillip, as was the 10-20% year end rally, but not sufficient to persuade fans and investors generally. A weak start to England's second innings implied a potential (and not unusual) collapse was on the cards; the market retreat in January and February were similar harbingers of doom. England's triumph was the March to August rally. However we shouldn't assume these rates of market growth will continue unabated, just as England still aren't world-beaters. As investors, we should assess our risk, asset allocate accordingly and maintain discipline, riding the good times and the bad times with composure. If we can do that, we'll have a stress-free life and a happy retirement – anything else just isn't cricket.

*Source Financial Express Analytics – FTSE All Share Total Return index year to 27 October 2008. All other performance statistics 9 March 2009 to 26 August 2009.
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