

Tashkent State University of Economics

Household finance

Lecture 13: Reasons for investment mistakes.

Lecturer: professor Otabek Karshiev

Basics: Two Kinds of Retirement Plans

- Defined Benefit – Pensions
 - Employer (maybe employee) funded on actuary calculation.
 - Invested by trustees.
 - Problem: Boom years under funding, enhanced benefits.
- Defined Contribution – Accounts
 - Funded by employee (& employer?) contributions.
 - Invested by individuals.
 - Problem: Under saving worsened by poor investing.

How did we do?

“Pension funds directed by trustees achieve results that are about 50% better than those achieved by individual investors.”

– Ed Dravo, The 4% Solution, Slate Magazine –
citing Federal Reserve Bank of Atlanta

Is there an 'Institutional Advantage'?

- Economies of scale?
 - Size does not correlate to performance.
- Information advantage?
 - Insider information illegal, unreliable.
- Smarter managers?
 - Same ones you can use; best pay not from pensions.
- Longer time horizons, more risk?
 - Aggregate time horizon same.

Who is the Problem?

“The investor’s chief problem, and even his worst enemy, is likely to be himself.”

– Benjamin Graham, *The Intelligent Investor**



**“By far the best book about investing ever written.”*

– Warren Buffett

A Look at Individual Investor Behavior



- Classical economics assumes self-interest drives rational, maximizing decisions.
- Behavioral economics asks how and why real people make real economic decisions.

Bounded rationality: Individual economic decisions are rational, within emotional bounds.

Flawed “Mental Maps”

Why Investors Chase Return

- ▶ “Representative heuristic”* – Seeing patterns where none are.

- ▶ “That fund has done well for 3 yrs, it must have a great manager.”



- ▶ Availability heuristic*
 - Depending on available, understood data, even irrelevant.
 - ▶ “I know and understand fund return, so I use it to predict future return.”

***Heuristic:** “A speculative formulation serving as a guide in the investigation or solution of a problem.”

Overconfidence

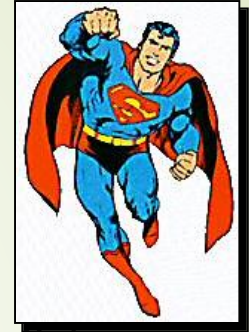
*Highest paid investors, lowest returns**

- Richer investors more confident, trade more.
 - More trades, the lower the returns.
 - Overconfidence encourages them to trade more, resulting in lower returns.
- Lower paid employees had better performance



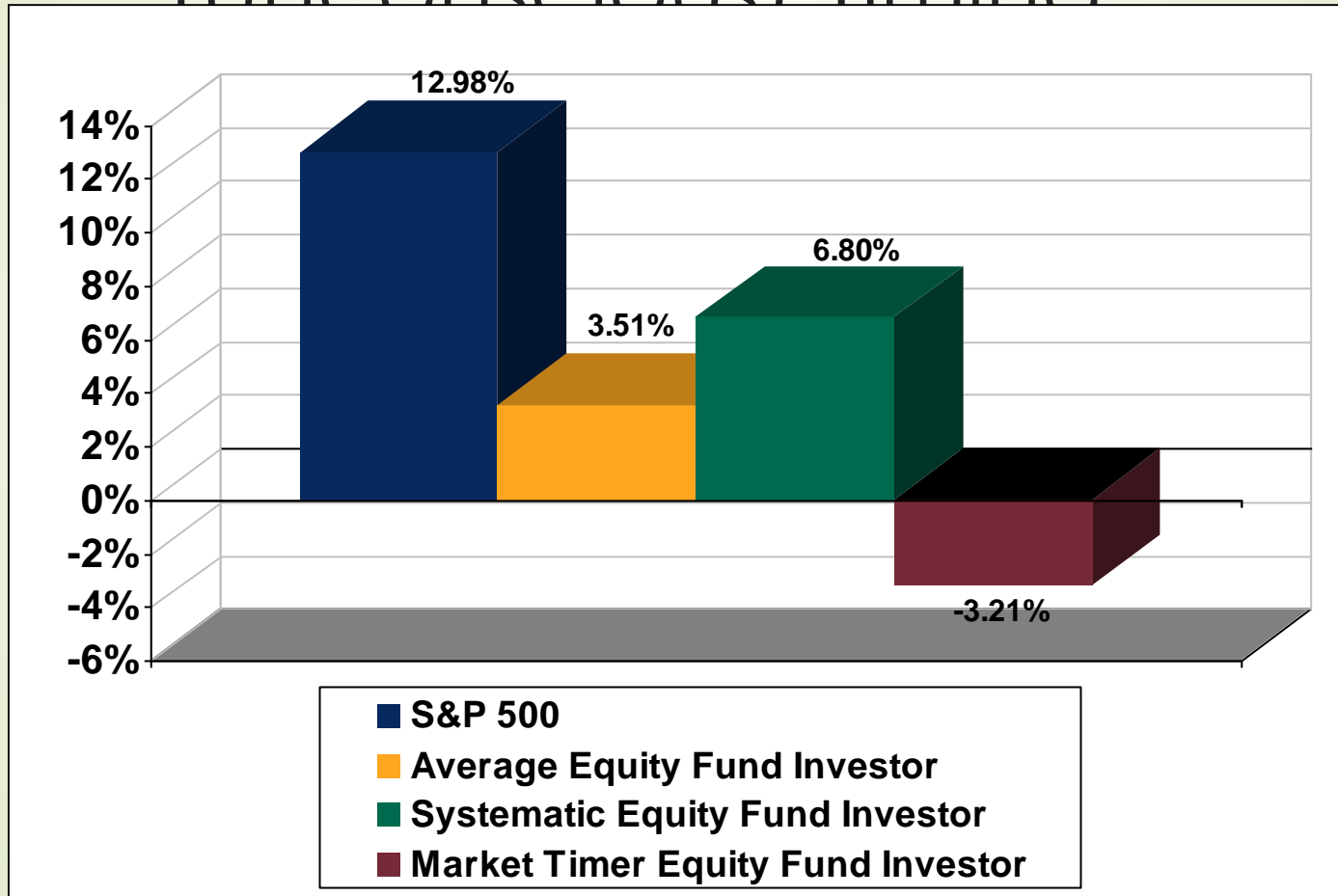
Overconfidence Result

"Trading is hazardous to your wealth."



- 1991-1996 S&P 500 return: 17.9%
- Average Brokerage account: 16.4%
- Brokerage accounts traded most: 11.4%
- Reasons –
 - Investor overconfidence, and
 - Broker advice (commission motivated?)

Result of Emotion Driven (Unconscious) Timing



'Expert' Forecasts Are Usually Wrong!

- ▶ 'Expert' market predictions, since 1929:
 - ▶ 23% of predictions expert were right.
 - ▶ Coin flipping is right 50%.
- ▶ You must be right 70% of the time to successfully time markets!

– William Sharpe

- ▶ A two sided decision.



How to Turn \$10,000 into a Grande Café Mocha

- From 1981 to 2002, you followed prior year's top performing investment advice service?
- Your results:
 - An annualized loss of 31.4%.



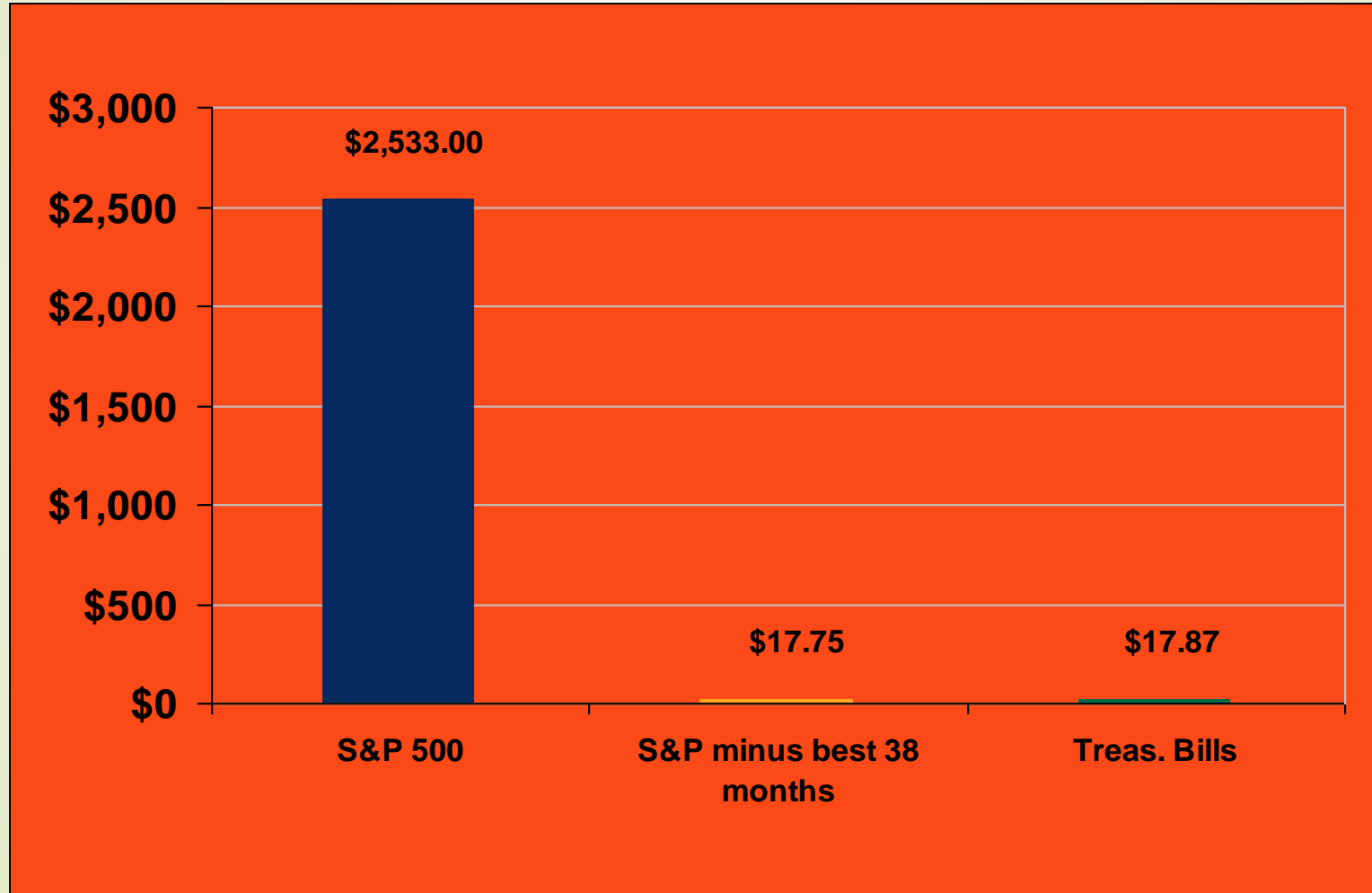
You have \$2.32 left from your \$10,000 nest egg!

Ask The Experts

- **William F. Sharpe**, Nobel Prize Laureate in Economics, *“A manager should avoid market timing altogether.”*
- **Warren Buffet**, Berkshire-Hathaway Chairman, *“I never have the faintest idea what the stock market is going to do over the next six months, or the next year, or two. But... it is very easy to see what’s going to happen over the long term.”*
- **John Bogle**, founder, Vanguard Group *“...trying to do market timing is likely not only not to add value... but to be counterproductive.”*
- **Peter Lynch**, legendary fund manager *“Rule number one: Stop listening to professionals!”*

When the Market Moves – 80

Hypothetical value of \$1 invested from year-end 1925–2004



Doing Nothing Is A Mistake, Too

- **No changes** considered as new investment choices are available.
- **No changes** as target date nears.
- **No changes** as your situation changes.
- **No changes** in thirty years!



Prospect Theory

Why Investors Unreasonably Avoid Risk

- Losses are felt more strongly than gains:
 - \$1 loss felt with twice emotional intensity of \$1 gain.
- “I’ll give up chance to gain \$2 to avoid equal chance of losing \$1”



People with brain damage impairing their ability to experience emotions make better investment decisions.

– WSJ Report, July, 2005

Confusion

*Too Many Choices, Lower Participation**

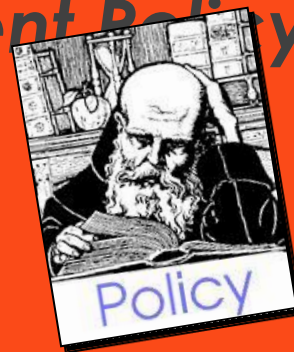


- Candy and Jam:
 - 24 jam varieties: fewer sales than with 6.
 - 30 chocolate varieties: less satisfied, fewer repeat buys, than with 6.
- Investments:
 - Each 10 new funds means 1.5% to 2% less participation.
- More choices means smaller differences between funds, trouble distinguishing, doubt.

The Institutional Secret, Revealed:

Pension funds take emotion out of
investing with policy driven
discipline:

Investment Policy Statement



Addressing “The Investor’s Chief Problem” with Your Investment Policy Statement

1. Purpose, Target Date
2. Risk Tolerance
3. Diversification/Asset Allocation
4. Portfolio Maintenance
 - a. Aging
 - b. Rebalancing
5. Accountability

