



Resisting temptation can have great rewards

Human beings have developed language, conquered gravity, and made the most of our opposable thumbs and infinite imaginations. What we're not terribly good at though, is overcoming our own worst impulses – particularly as investors. In a volatile market, the temptation to chase the perfect investment can be almost irresistible – but the payoff just doesn't match up.

ARE WE WIRED FOR FAILURE?

Could it be that the way human beings are psychologically made up makes it difficult for us to pursue an optimal investment strategy? Are we somehow wired to be more susceptible to behaviour that produces less-than-great results?

This theory comes from various neuropsychological research. In one particular study¹, after observing a series of light flashes, human subjects were asked to guess whether the next flash of the light would be at

the top or bottom of the screen. The order that the light appeared in each location was random, but over time it appeared at the top of the screen 80 percent of the time. The non-human subjects, rats, were required to do the same thing. If the rats were right they got food, and if they were wrong they got a mild electric shock.

The scientists noticed the subjects engaged in two very different types of behaviour. The rats employed a 'maximisation' strategy, while the humans preferred a 'matching' strategy.

MAXIMISING VS MATCHING

The 'maximising' rats weren't capable of cognitive thinking. They just engaged in the behaviour that most often gave a positive result. The rats soon learnt that the light flashed most often at the top of the screen, so eventually they only selected the top – and were rewarded with food 80 percent of the time.

The human 'matchers' also figured out that the light flashed most often at the top. But they tried to figure out the underlying pattern to the random flashes. They tried to match their guesses to the (non-existent) pattern – and only guessed right 68 percent of the time.

In theory, this strategy does hold the possibility of always being correct. If the subjects' guesses exactly matched the random outcomes, it is conceivable they could have guessed correctly 100 percent of the time. In practice, though, the maths doesn't work out this way.

So, according to this study, humans do not perform as well as rats when it comes to predicting random outcomes.

OUR NEED TO BE RIGHT MAKES US WRONG

The psychologists hypothesised that rats choose a more optimal strategy than we oh-so-smart humans because they have no desire to be precisely correct. Instead, the animals accept they're going to be wrong some percentage of the time and simply want to minimise the error (and risk of shocks). Humans, on the other hand, aspire to be perfectly correct – and, as a result, we're wrong a higher proportion of the time.

So, what does this have to do with investing? The random outcomes tested in these studies are much like the day-to-day variations we see in financial markets. Our need to find patterns in uncertainty actually causes us to do much more poorly than if we, like the rats, simply pursued the best long-term strategy and accepted we'll receive a few 'shocks' along the way.

INVESTORS ARE GREAT AT PREDICTING THE PAST

Chasing performance, or 'recency bias', is a good example of how we alter our behaviour based on recent events. If a stock does well, investors are likely to flock to it (buying high). If it drops, many investors will flee (selling low).

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Studies show super fund members in Australia have a similar mentality. The majority of investment switching during the global financial crisis happened just after market downturns, and most of those transfers were from medium- or high-growth portfolios to more conservative strategies. Those who switched to cash during March 2009 (when the market was at its lowest point) were six percent worse off by August that same year, having missed out on the sharp market rebound.ⁱⁱ

Investors turn out to be great at predicting the past, but we're not terribly good at guessing what's going to happen in the future.

HOW TO BREAK THE MOULD

So what can we do to improve our chances of investment success? The answer, of course, is to ignore your very human gut instincts and behave more like a rat. Determine the optimal plan based on your retirement objectives and tolerance for risk, then stick with it. You don't have to change your super investment strategy as soon as the market moves – in fact, it's best not to.

It's humbling to realise that by giving up the chance to be perfectly correct, we might actually improve our investment success to the level of this low creature. But then, humility has always been a valuable trait. Maybe in investing this is truer than we ever knew.

ⁱGazzaniga, M (2002), The Split Brain Revisited, Scientific American, p26–31

ⁱⁱGerrans, P (2009), Member Investment Choice Response to the Global Financial Crisis, The Australian Institute of Superannuation Trustees