When is it Bad to Have Good Choices?

Irrational Expectations, Irrational Behaviour, Rational Outcomes.

Market crashes are the eye of the needle that investors pass through in their quest to create wealth. They are dangerous, watershed moments where the probability of impairing your capital, reputation and career is at its highest. Collectively, the misery created by these losses is known as ***negative infinity****. We find it curious that investors get ensnared by crashes time and again despite having at least two options, namely (i) cash, and (ii) high quality equities that drastically reduce the probability of suffering negative infinity. Further, we trace the reason for investor tendency to abandon certainty in favour of uncertainty (by mislabelling risk as value as well as herding through peer indexing) using cognitive and behavioural psychology. So strong is this tendency that betting against it is a reliable source of alpha for us.*

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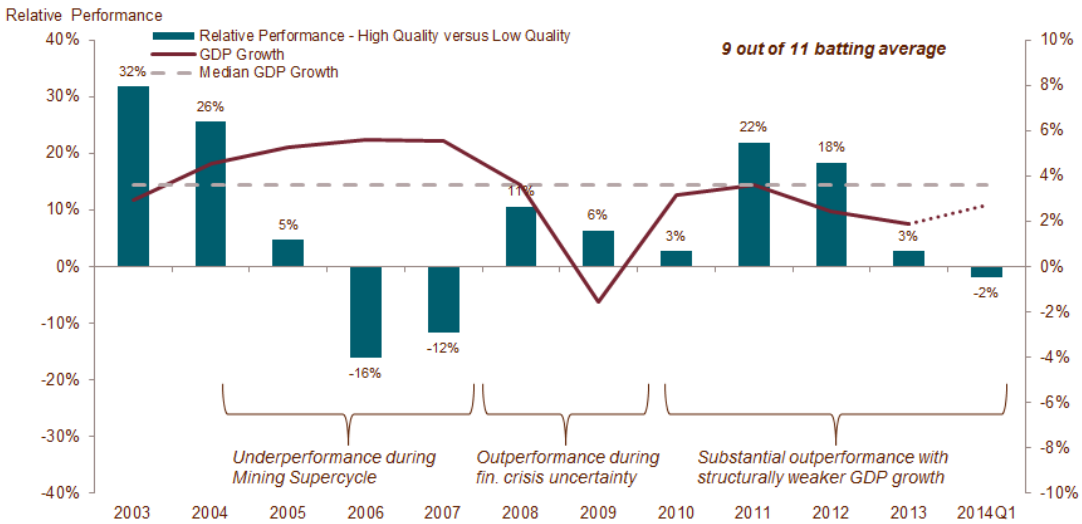
Choices as You Peer Towards the Horizon

Let's take it from the top. The top of the cycle, that is. As the market corrects, anticipating a roll-over in the economy, investors behave in a way you would expect any rational, thinking person to do: either they abandon the equity market – if they haven't already – or they seek out companies that will navigate the coming period of economic distress with as much certainty as possible, if they haven't bought into such companies already. Both actions result in cash and/or high-quality companies outperforming the broad market index, as well as cyclical, low-quality (marginal) companies. The outperformance of cash and high-quality equities over the market and low-quality companies reaches its apex at the trough of the cycle, and slowly (over the ensuing three or so years) narrows, as investors anticipate and observe a recovering economy through personal experience and news flow. Our empirical analysis of the performance of high-quality companies over cyclical companies bears this out. Indicatively, Figure 1 shows that high-quality companies gave you enormous protection – with no use of derivatives – against the market crash and economic malaise that followed for three years.

Figure 1: Relative Performance of High Quality vs. Low Quality Relative to GDP Growth, 2003 - 2014Q1



Describing and explaining phenomena such as this leads to heightened understanding or enlightenment – itself a necessary condition for success in any area of human activity, including wealth creation.

It is difficult to quibble with the rationality of the behaviour described above. It is one whose psychology is explained by both cognition and emotion – an overload of fear. What exactly would investors recognise and be afraid of simultaneously? The total impairment of their capital or the erosion of the purchasing power of their savings to such an extent as to cause them to live out the rest of their lives in a manner markedly inferior to their current experience. Their definitions of who they are would be tied to both ignominious outcomes.

This explanation is not culture-, geography-, ethnicity-, religion-, or gender-specific. It is simple human instinct to seek certainty when enveloped by uncertainty. The greater the uncertainty (think of 2008), the greater the certainty desired – just ask a person recovering from a near drowning experience. In short, it is instinctive for a human being or any other animal to attempt to save himself when faced with certain death. If that means abandoning the stock market to save the life you know and have dreamt of, so be it. Failure to salvage the situation ends in tragedy at times. Investors are known to have jumped to their deaths from high-rise buildings the instant they realised that they have lost all their savings. Let us bear in mind that the operating definition of investing is not just protecting your capital against the erosion of its purchasing power, but also earning an actual premium on that protection.

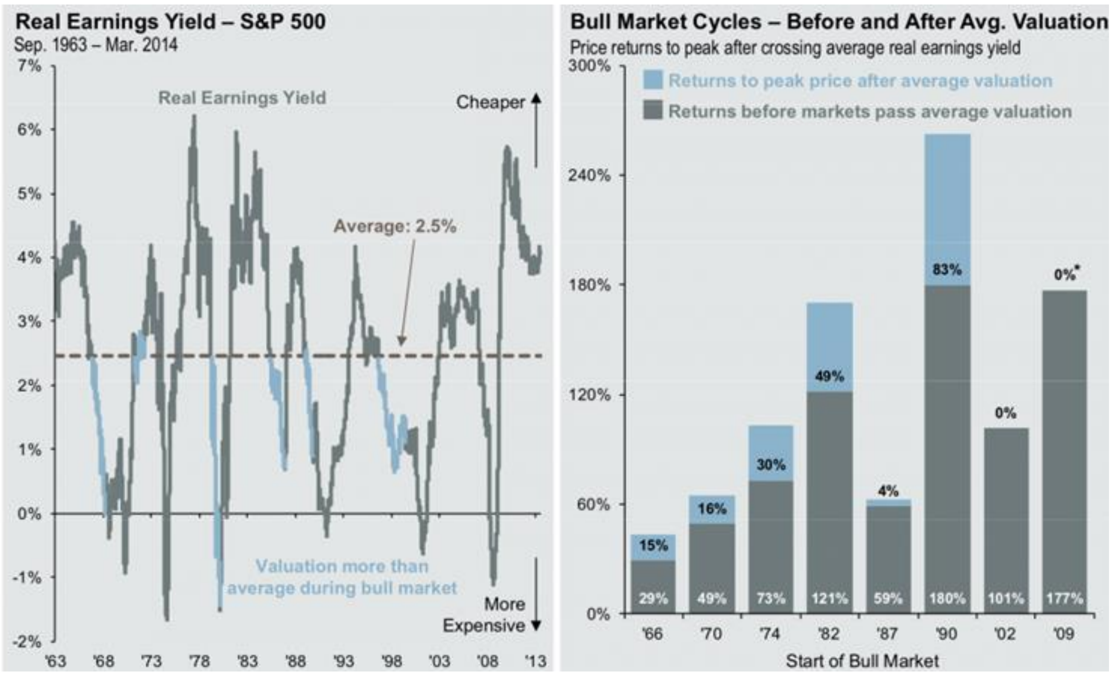
The purpose of this paper, however, is to investigate the inverse of what we have just described and explained – the reason investors find themselves in the miserable position of having to either sell their exposure to the broad market in a correction, thereby deepening it into a crash, or swapping into companies that can handle the coming cyclical risks with greater certainty. As mentioned earlier, it is not as if they did not have good options to protect their capital in the run-up to the crash in the form of: (i) high-quality companies that will, in fact, benefit as marginal companies struggle to serve what commercial needs remain to be found in a terrible economy; and (ii) the safety of cash.

Abandoning Certainty for Uncertainty

It turns out that the worst part of the investment cycle is about two thirds of the way into an economic recovery, because signs of economic normalcy, if not prosperity, appear with greater frequency than they did just three years (or so) earlier. Those blessed with eyesight often believe that your eyes tell you all that you need to know; that the acquisition of security, ranging from employment to credit availability, to the consumption of erstwhile desires such as clothes, cars and houses, is not just possible, but on the rise. Marginal companies now join high-quality companies that are fundamental to the structure and shape of the economy in servicing rising demand. As investors anticipate improvement in the fortunes of cyclical companies that add to the ambience, but not shape, of the economy, the outperformance of high-quality equities over the broad market and low-quality companies turns into underperformance. To compound the problem, by this time, the investor's memory of the previous crash has greatly faded. So what could be so wrong about this to justify us labelling it the worst part of the investment cycle?

Because investors do the unthinkable: they abandon high-quality companies that create wealth for them with certainty, not in favour of cash, but rather in favour of cyclical, low qualities that contribute to economic growth at the margin. To illustrate: you would not associate the relative outperformance of the gold industry year to date (37%) with an industry that is in a decade-long structural free-fall, detracting from economic growth and employment. The question or puzzle over here is: why would investors exchange the certainty of high-quality companies for the uncertainty of intermittent profits, having seen, and knowing full well, the misery that is sure to follow? Cycles are well known. Cycles have come and gone. Cycles have been studied extensively and one of the findings we are very familiar with is that they cannot be timed because they are irregular (see Figure 2). So why then would investors do this?

Figure 2: The Anatomy of a Cycle: Irregular in Duration and Strength



*Note: Valuation based on real earnings yield of the S&P500 which is defined as (trailing 4 quarters of reported earnings / price) – YoY core CPI Inflation. Period after average valuation defined as 15-day moving average passing below average real earnings yield. *The return to peak price for the current bull market is 0% as the S&P 500has yet to cross the long run average real earnings yield*
Source: Standard & Poors, JP Morgan Asset Mgmt

Your eyes do not, in fact, tell you all that you need to know. That's the simplest answer. Yet that is not the kind of explanation that enhances your understanding of the irrational behaviour we just described. As the saying goes, **there's more to it than meets the eye**. Before we continue our explanation of the phenomenon, let us define two words we have used generously thus far – "risk" and "certainty". Firstly, risk is the outcome where your capital either loses its purchasing power or gets totally impaired. Money cannot exist in any form whatsoever without facing this possibility. Secondly, certainty is the quantification of this possibility by way of mathematical probabilities. "Very risky" indicates a high probability of your capital either being impaired or losing its purchasing power. "Not risky" indicates the opposite.

In addition: while the brain is an immensely powerful tool, let's not take liberties with how it works. The English-born, Maltese psychologist, Dr Edward de Bono, who pioneered studies and authored books on thinking and creativity, concluded that it is not natural for man to think. Like other animals, man is happy to go along on instinct. However, his physical disadvantages in the wild led to the development of thinking faculties in order for him to survive. To illustrate – the instincts of many investors are piqued by shorthand metrics, such as price-earnings multiples and dividend yields, to the point that they are happy to make them into valuation rules. That is, until a high-risk event forces them to dispense with instinct and create new thoughts about valuation that better adapt to that event. Hence the development of intrinsic valuations requiring discounting or present valuing of cash flows. This is a cognitive response to failure. As a result, we can conclude that since man left the wild planes, his brain exists to produce discernible and adaptable action (looking at someone's actions reveals the quality of his thoughts).

This is precisely the reason why the workings of the world resonate with different people to varying degrees (simplistic, low, medium, high, superior, and genius). Investment (and other) outcomes (in life) are therefore a function of an investor's (actor's) resonance with, and adaptability to, the workings of the world. This is why many areas of human activity, not least of which is the stock market, are complex, adaptive systems. It is therefore imperative to address both cognitive and psychological aspects of investor behaviour in the explanation of why investors become embroiled in market crashes.

Cognitive Misjudgement – Mislabelling Risk as Value

Cognitively speaking, the answer must be that investors **mislabel risk as value**. That is, they assign greater certainty to companies that play at the margin of the economy. Valuation expert, renowned author and academic, Aswath Damodaran, found that 85% of research reports and 50% of corporate mergers and acquisitions are based on shorthand valuation metrics[1]. In other words, more often than is helpful, investors revert to instinctive action rather than creativity (creating new thoughts). To illustrate – African Bank announced its profit warning just more than a year after trading at an 8% dividend yield and 4,4x price-earnings multiple, and ended up bankrupt less than five months later. Despite that, the ensuing rights issue was well supported on the basis of valuation, which has proven to be a clear mislabelling of risk as value.

[1] Aswath Damodaran. 2001. *Relative Valuations*. p. 136

Why is the phenomenon of mislabelling risk as value a structural inefficiency that yields a reliable source of alpha for us at First Avenue? Because every purchase has a sale and, typically, a high-quality company (e.g. FirstRand) would have made way for a low-quality company from whom a cyclical bounce is expected (e.g. African Bank). But how exactly do investors associate risk with returns? A core tenet of the Capital Asset Pricing Model (CAPM) states that higher returns are a function of an investor's willingness to take on greater risk. So powerful is this argument that it is one of the central themes of a Master's in Business Administration (MBA) curriculum. It is also central to the curriculum of the Chartered Financial Analyst (CFA) qualification.

During analysis, investors "stress test" financial projections of a firm by increasing the rate at which they discount future cash flows for risk, and find value in a stock if the resulting valuation is higher than the ruling share price. The one factor that valuations are most sensitive to is the discount rate. So, think about it systematically, now: having acknowledged the riskiness of a business by raising his discount rate, and still getting a valuation higher than share price, the investor feels comforted to swap out of a safer company into one he has just acknowledged is unsafe. The answer such investors give is bulletproof: Yes, I know it is a risky company, but that riskiness is more than reflected in the share price. Smart, very, smart. Right?

Wrong. That logic is akin is to negotiating a tight anti-nuptial agreement with a partner you recognise is bad news. Anyone married, or contemplating the institution, knows not to do this. In fact, they would find the suggestion of marrying a patently bad partner on account of "valuation by way of an anti-nuptial" absurd. Yet most experienced investors, even those who are long in "marriage", turn around and invest on the basis of this absurdity. They leave their beautiful, safe partners every morning to go into work, where they commit to marginal stocks on the basis of a "pre-nuptial". And then, they get spooked when such a company calls in the pre-nuptial by way of a rights issue. One of the major teachable lessons of the African Bank debacle is that there is a point past which risk is priceless, especially after witnessing deteriorating fundamentals every six months for the past two years.

As an aside, financial promiscuity in South Africa has saved the country from many more bankruptcies than we've experienced, because new "husbands" have jumped in to take over the "ex-husband's" pre-nuptial (subscribed to rights issues), when companies called it in. So the stock market has an artificially high survival rate. This has created a moral hazard of management adopting more and more risky strategies (we now know more about how imbecilic African Bank management was with unsecured credit), investors going up the risk curve on the basis of "valuation", with full knowledge that someone else will bail them out (a large investor in the company, or the Government) if the risk they knew to exist actually comes to pass. An investor who has seen this happen time and again has every reason to believe that investment outcomes are in fact risk-agnostic. And why wouldn't it be part of their cognition – their eyes have told them all they need to see.

Psychological Misjudgement – Peer Indexing leading to Herding

The most rigorous explanation for the error we are describing is found in the field of psychology. It would be too simple to call it greed. In the annals of psychology, it is referred to as **Buridan's Ass**.

Figure 3: Buridan's Ass

Buridan's Ass
A situation demonstrating the impracticality of decision-making using pure reason

In the 14th century, a French Catholic priest, Jean Buridan, wrote extensively about actions that arise out of free will. He told of an apocryphal ass (donkey) that starved to death, despite standing between two equally appealing stacks of hay (see Figure 3). The donkey was so overloaded with greed (trying to maximise its choice) that it did not know which stack of hay – and it had to choose one – to eat. You can easily swap out the donkey for the investor and place cash on the left and high-quality shares on the right. Given these two protective options, in the face of a known and needless-to-time correction, why would an investor end up in financial ruin? The investor, having succumbed to the leadership of risk assets, is also trying to maximise his choice between the two options, while staying with what is outperforming. The end result is that the investor procrastinates and ends up rolling over with the cycle, suffering financial ruin no differently from the donkey ending up starving. Capitulating after the crash as final acknowledgment of risk, not value, is no different from the donkey finally deciding on which stack of hay to eat, albeit stale.

Psychologists have associated this indecision to stimulation-overload, which kicks in any time an individual has two or more good options to choose from. He just cannot seem to choose one, without the rejection of the other causing him anguish. You could not ask Michael Jackson to have just the one cosmetic surgery operation that would make him handsome (beautiful in his case). He went back for more until he almost ruined his face. Ask any mercurial young man or woman who now has to choose one out of two lovers to marry. The anguish of missing out on the other possibility, not so much inflicting pain on him/her, causes the decision to go unmade until the partner they actually want, if not both of them, walk away out of disgust, consigning the youngster to enormous emotional trauma. The popular US television show, The Bachelor (there is a female version, The Bachelorette), is based on the principle of Buridan's Ass, only with a twist; namely, the donkey – bachelor or bachelorette – is forced to choose whom they'll walk into the sunset with. Otherwise, what man voluntarily whittles down a harem to one? The calamity that follows indecision is known as **negative infinity**. Applied to the market, what investor chooses cash or safe companies when a raging bull market suggests anything but that? Negative infinity is what follows.

If you are free to make one choice out of an abundance of good choices, what in your head stops you from making it? Swathmore University psychologist, Barry Schwartz, renamed Buridan's Ass "**The Paradox of Choice**". The answer is that when something makes you anxious, even the mere fact of having to choose, you tend to avoid it or put it off. The more the options you have, no matter how appealing, it is missing out on what you do not choose that causes you anxiety. We are not referring to choices between high value and low value options such as an iPod and a pretzel, respectively. Those are easy. We refer here to difficult choices faced by investors in the fifth year of a bull market – forgo returns in the latter end of a bull market in return for protecting your savings against an untimely crash. Investors choose neither of the protective options available to them and end up with untold misery (negative infinity). Put another way, investors who choose to maximise returns by choosing neither cash nor lower-yielding, high-quality equities are prone to misery and depression.

If you have a tendency to maximise, and there is real pressure to do so, economic theory compels everyone to maximise shareholder returns – there comes a point in the consideration of choices where just one additional option can produce outright paralysis. Psychologists Amos Tversky and Eldar Shafir asked shoppers how they would react to a desirable Sony appliance placed in a shop window, radically marked down. Predictably, they were met with unbridled enthusiasm from all the shoppers they polled. It really was a no-brainer. When a second, similarly marked down item was placed alongside the bargain Sony, enthusiasm and sales dropped. Evidently, some shoppers were frozen by indecision.

To avoid this trap, Professor Schwartz of Swathmore suggests that decision-makers pursue satisfaction rather than maximisation – they are content with what is merely excellent as opposed to the absolute best. What intensifies investor tendency to maximise is that some of them have built "**Peer Review/Peer Indexing**" mechanisms into their investment processes. While this mechanism is intended to ensure that their performance does not lag behind that of their peers and result in outflows, it actually causes business through "**herding**". Incidentally, **career risk** also plays a considerable role her. As large managers count the reputational costs or business risks resulting from their holdings in African Bank, it is most likely that one of the questions they are privately pondering is whether they would have held the stock (and in that quantity), if their peers hadn't.

Passing Through the Eye of the Needle: High-Quality Investing

Given that we are predestined to maximise (part of the animal instinct in us), it is not clear how we can wake up one morning and simply decide to convert to being satisfied. Tell a man in the throes of a four-year bull market to be satisfied with what he has so far made out of the market and that (i) cash or (ii) high-quality equities will see him through the cycle if he forgoes his desire to maximise what he can make. He will not disagree with you, but he will not comply with the options you present to him. Try it. In the same fashion, grocery lists short-circuit over-wanting or maximising and cut out the negative infinity that comes from regretting impulse purchases.

Christopher Caldwell, in his article "Select All: Can You Have Too Many Choices", tells the story of how a radio station prevented the problem of negative infinity caused by indecision. The bosses at the radio station called in the producer and told him of his promotion on the grounds he was a "good decision-maker". Recollecting some of his past failings, he reminded his bosses that many of the decisions he had made since joining the station had not exactly worked out. They did not care. "Being a good decision-maker means you are good at making decisions," one executive told him. "It does not mean you make good decisions." The boss understood that the station had less to fear from periodic errors than from the day-in, day-out paralysis of someone too cowed by the choice to choose at all – someone hampered by negative infinity. At First Avenue, we have taken away the potential for indecision by narrowing our investment options to the one strategy that can "pass through the eye of the needle" at all times, namely, investing in high-quality companies. Correspondingly, this is also why we don't proliferate product, such as sector and style funds, as much as they may maximise our revenues.

Choosing either cash or high-quality equities is far better than the paralysis that eventually consigns investors to experiencing market crashes. Until investors adapt their investment philosophies and valuations to that fact, we at First Avenue will continue to buy companies rich in intrinsic value when investors sell them in favour of potentially outsized, but highly uncertain, returns. Our objective is not to get our **clients to the peak of the cycle, but to get them through it**. We hope you are satisfied with that.

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