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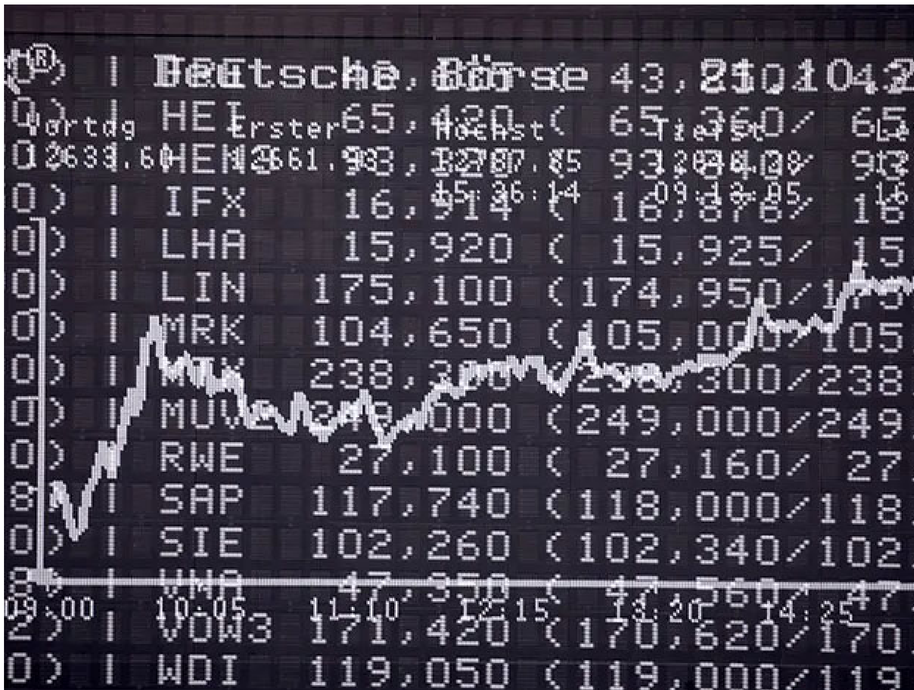


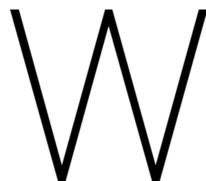
INVESTMENT IDEAS

Ideas Farm: Winning the losing game

We can limit the likelihood of making mistakes when markets fall by embracing uncomfortable truths and resisting our common urge to indulge in fantasy

July 15, 2021
By **Algy Hall**

- Heads I win, tails I don’t lose
- Investing has little downside in our imaginations
- Shame that’s not true in reality
- We all need an investment plan based in reality
- Loads of new idea-generating data



hat happens to our investments when the market falls? Some fascinating research published in March provides insights into what investors think happens compared with what is actually likely to happen. The findings highlight why it is so important to use formal strategies to help overcome dangerous psychological pitfalls.

In October 2019, academics Christoph Merkle and Michael Ungeheuer, respectively from Aarhus University and Aalto University, carried out an online study on 771 people. The participants generally demonstrated good financial literacy and spanned a broad age range from 19 to 76, with an average age of 36. 57 per cent claimed to be investing in risky assets at the time.

The participants were told to either select a portfolio of stocks (two or more) from the 30 constituents of the Dow Jones Industrial Average or were randomly assigned a portfolio of between three and nine stocks. They were then asked to say what return they expected from their holdings over the next year based on a variety of market returns. Market returns ranged from a 19 per cent gain to a 19 per cent loss.

For behavioural finance fans, it probably won't come as much of a surprise that participants displayed overconfidence. That was true whether they selected their own holdings or were assigned a random portfolio. Indeed, psychologists found ample evidence that we all overrate our abilities as investors. And there is also plenty of evidence that we see superior attributes in a thing we own compared with the same thing not in our possession - the so-called 'endowment effect'.

However, it was the circumstances in which participants felt most overconfident that is particularly illuminating. While portfolios were generally expected to capture the benefit of the Dow's upside in a fairly proportionate way, when the index fell, portfolio losses were expected to be much less. There was a clear inflection point in participants' realism when market returns went past zero.

For example, investors that selected their own portfolios had an average expectation that when the market fell 15 per cent, they would lose about 5 per cent. What's more, while these results were most extreme for self-selected portfolios, they were also very evident for participants that had portfolios randomly assigned.

The study found the self-selected portfolios were on average actually slightly riskier than the market. The results also represented a general trend in behaviour rather than a few extreme responses.

It's easy to see the results from this kind of research as someone else's problem: The participants must be nitwits. This would never apply to you and me… would it?

Sadly, it would. The value of research into common human behaviour is that it is common. It is hardwired into our brains through millions of years of evolution. It reflects the thoughtless decision-making humans

needed to survive and thrive in the real world since emerging on the Savanna plains rather than the behaviour needed to beat markets over the past few centuries. Investors need to find tricks to overcome these shared psychological flaws.

A key lesson from the research is that the well-documented trait of 'loss-aversion' not only causes us to react badly to losses in the moment, but also means we prepare ourselves badly ahead of these inevitable events.

There is some key prep work all investors can do: (i) have a written plan to how you will respond to large drawdowns prepared well ahead of time; (ii) write your plan as advice to another person (we all live with idealised images of ourselves); (iii) and always pay attention to base rates (the market return is likely to matter a lot to your portfolio).

Read the research paper here

Read our free seven-step guide to harnessing the insights of behavioural finance to become a better investor here

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