Loss is not as bad as wanting more

- Lao Tzu

“Risk-averse” is often used as a description of a rational investor. However, “aversion” is not a logical desire to minimize. Aversion is fear and disgust. When we “avert our eyes”, we look away. The term risk-aversion, in fact, gets right to the heart of the behavioral side of finance. We are afraid of losing money – and perhaps even more powerfully, we are afraid of the embarrassment that comes from being a loser.

Investors who are highly afraid of losing money are also powerfully motivated to find what we have called a Silver Bullet – the sure-fire investment that is guaranteed to make them look like a genius. They do not want to monitor their investments – they do not want to look at their money at all, or at anything that may cause them embarrassment. They are desperate to find the one investment that will always make money and never make them look bad. They want to win the lottery.

The greater risk therefore is not inherent in this or that investment. The investor is the risk. The irony is that this means the more risk-averse an investor is – the more fear they have of losses, and the greater disgust if they lose – the higher the likelihood that they may engage in risky investment behavior which will result in losses. Through their actions (or inactions) they invite the very outcome they fear. Will the investor be willing to monitor their investments, challenge ideas, admit mistakes, and try something new? Or will he or she trust in the next Silver Bullet, cross their fingers, avert their eyes, and hope for the best?

To realize you don’t understand is a virtue

- Lao Tzu

When large groups of investors simultaneously engage in this wishful thinking about a particular asset, we refer to it as investor complacency (Investor Complacency Makes Us Nervous, February 2013). The false optimism creates an illusion of knowledge and leads to overconfident, ill-thought-out decisions. For a time, perception becomes more powerful than reality. Investors have a tendency to extrapolate the recent past into the future – the wrong belief that whatever happened yesterday is likely to happen again tomorrow. When credit spreads reached record lows in 2007, for example, it was heralded – even by long-term investment professionals – as a sign that debt had somehow permanently become less risky. But it was not the asset class that had changed its spots. It was investors’ perception that had changed. The mindset for the boom was entrenched; the stage for the bust had been set.

Therefore it is not the risk of this or that asset that is the enemy of the investor. It is the investor’s own misperception of risk that is the villain.

Those who have knowledge don’t predict

- Lao Tzu

Tackling the villain of risk misperception does not require becoming a hero. It just needs recognition that monitoring risk and fearing risk are not the same thing. Asset classes do tend to boom and bust, which means that the risk environment is not flat. Risks may be rewarded consistently over very long stretches of time, but they are not rewarded consistently throughout a given cycle. Investors must be willing to make buy and sell investment decisions not on what did well or poorly yesterday, but to take an honest look at the risks present today and whether they are likely to be adequately rewarded tomorrow.

Evaluating risk is not a question of market timing. For example, you may reference Galway’s newsletter from November 2009 to see that we have felt the return on interest rate risk has been inadequate for four years. We have held an allocation...
to TBT, the ProShares 2X Inverse Long-Dated US Treasury, to hedge interest rate risk. During that time TBT is down significantly. Now, how we view that loss very much depends on the lens. If our aim is to impress folks by timing every trade so that it makes money on a stand-alone basis, by that metric TBT can only be viewed as a shameful failure. However, if we look at the excellent performance of our bond portfolio as a whole, which has more than doubled the Barclays Aggregate over that time with only a quarter of the duration, TBT is part of a resounding success story of picking risks that have been rewarded.

The world is won by those who let it go

- Lao Tzu

So, if neither seeking the euphoria of a win nor avoiding the shame of loss is the path towards rational investing, what is an investor to do? Ironically, although modern capitalism is a thoroughly western institution, the western addiction to perfectionism is counterproductive. Investors would do well to incorporate a little eastern philosophy and adopt a 'Tao of Investing'. Lao Tzu, founder of Taoism in China in the 6th Century BCE, made a few observations that may help investors to overcome the current western malaise of context-less and unattainable perfection.

- Loss is not as bad as wanting more There is no Silver Bullet investment. Don’t waste time trying to find it.
- To realize that you do not understand is a virtue The world changes every day. Monitor your investments, not because of fear they might be wrong, but because they evolve.
- Those who have knowledge don’t predict Making decisions on risk is not about trying to time the market or predict the future.
- The world is won by those who let it go. You are not defined by your investments. Release the fear and shame that can cloud your honest judgment.

As always, we are proud to be your partners in intellectual exploration and stewardship without compromise, and in pursuing the Tao of Investing.

Best Regards,

Liam Molloy, CFA
Founding Partner
liam@galwayinvestmentstrategy.com

Bethany Carlson, CFA
Founding Partner
bethany@galwayinvestmentstrategy.com

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www.galwayinvestmentstrategy.com