INVESTOR EDUCATION

Equity Investing is a Zero-Sum Game: Understanding Behavioural Bias

Henderson Rowe is disrupting the UK market by delivering institutional-quality investment solutions directly to private clients. In this investor education article, **Stefan Cooksammy**, an Investment Manager at Henderson Rowe, explains that institutional investors consistently outperform retail investors. To understand why – and how to use this knowledge to your financial advantage – you must first understand that equity investing is a zero-sum game.

Warren Buffett invoked a poker metaphor in a 1988 letter to Berkshire Hathaway's shareholders to illustrate this:

"If you aren't certain you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, if you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."

Like poker, outperformance in the stock market is a zero-sum game. In other words, for every winner in the equity market there must be a loser.

The losers in equity markets are usually retail investors and their managers who tend to overestimate their own prowess. The winners, of course, are typically institutional investors. These latter players have the resources to be professionals at something that, for most people, is an amateur pastime at best.

Behavioural Bias: The Reason You Are Losing

In a future article, I will explain how you can exploit behavioural biases by changing your investment and asset allocation approach. But in this article, let me focus on a more fundamental question: why do institutional investors outperform retail investors?

It is because investor behaviour is governed by subconscious bias, and individuals don't know enough about the nature of that bias to correct their mistakes (let alone profit from the errors of others).

Put simply, a behavioural bias is a predisposition that impacts an investor's behaviour. To extend the poker metaphor, you can think of these biases as "tells." They are immediately recognisable to professionals. However, they are usually hidden from amateurs. Institutions exploit these retail biases – these "tells" – to take home the lion's share of the equity market pot.[1]

An example could be helpful. In markets, one often hears the adage "the trend is your friend"—a description of so-called "momentum" in stock prices that sees the winners keep winning and the losers keep losing. This predictable pattern in prices seems, at least in part, to result from a common behavioural bias referred to as the disposition effect.

The disposition effect is based on a simple intuition about how investors perceive gains and losses. Most investors love the feeling of booking profits but hate the sensation of locking in losses. This drives non-professional investors to sell their winners too early but hold onto their losing trades for far too long –

sometimes even buying more on the way down – hoping for a rebound.

With so many individual investors trading against the trend, prices tend to "drift" up or down over a longer horizon than one might expect, taking months as opposed to minutes to price a piece of good news. Professionals exploit this bias, purchasing shares in stocks with a positive trend from individuals as the price marches up and selling shares to individuals as stocks with bad news plunge.

Many sophisticated institutions have objective controls in place to avoid getting caught up in trading motivated by biases like the disposition effect. The simplest of these controls are quantitative, but the most effective tools – not only for detecting bias, but profiting from it – blend quantitative and fundamental insights to identify cases, for example, in which irrational framing of investors' gains and losses could be keeping a stock away from its intrinsic value. Trading against that bias places institutions on the profitable side of the stock market's zero-sum game.

Dunning-Kruger Effect: Behavioural Bias on Steroids

Many clients think they will be protected against retail mistakes if they hire a private investment manager. Indeed, one of the most valuable services an investment manager should provide is to insulate clients from their potentially self-destructive behavioural quirks. Unfortunately, private managers are subject to the same biases as their clients. Even worse, these managers often double down on errors, precisely because they believe they are experts. Their egos prevent them from acknowledging their own biases and mistakes.

Here we see another bias at work: the Dunning-Kruger Effect. This clinically proven bias causes people with low self-awareness to overestimate their own capabilities. Because the UK private client market is primarily about sales – not investment capability – it attracts people who excel at selling and working with clients. But these individuals are not necessarily the best researchers or investment managers. Their egos simply won't let them admit it.

There is no shame in being skilled at client servicing and education – not everyone can be Jason Hsu or Ray Dalio. In fact, client service and education are probably the most valuable elements of the retail investment management business. The major risk arises only when managers can't admit the limits of their own experience and capabilities. Ego causes these managers to overestimate their competence, which magnifies – rather than reduces – the risk of behavioural bias. These managers stake out poorly informed, ego-driven positions using their clients' money – and their mistakes are eagerly exploited by institutional investors.

Attribution Bias: The Dangers of Good Luck

Of course, sometimes even bad managers get lucky. This is a very dangerous situation: an overconfident, ego-driven manager with a string of good fortune. Noting a manager's recent "success", investors turn over their hard-earned money without recognising the manager has simply been lucky. Adding insult to injury, these managers may also charge increased fees based on strong recent performance.

Objectively, we know the research shows that investing based on recent short-term performance is a big mistake. In fact, if any correlation exists, it's a positive association between good recent performance and poor future performance. One oft-cited study notes that "five-star" funds, whose ratings are based on recent performance, underperform "three-star" funds, on average, over the next three

years. Based on this research, you might just as well select funds based on recent bad performance, with the understanding that performance will revert to the mean in coming years.

Unfortunately, while this research is intuitive, our behavioural biases make it difficult to act on the knowledge. This is because managers and their clients experience what is known as self-attribution bias. This bias causes people to attribute good outcomes to skill, but to disregard bad outcomes as a bout of bad luck. Managers and clients experiencing attribution bias will often postpone important decisions or even double down on bad investments. When this happens, institutional investors are all too happy to take advantage.

Exploiting Behavioural Biases

Don't be discouraged by the information above – there is good news! Because once you are conscious of behavioural biases, you can use this awareness to your advantage.

To begin with, the self-aware investor may easily select managers and strategies who control for such bias. There are many quality managers in the UK who recognise the limits of their own capabilities and resources. Unlike predatory high-net-worth managers, these advisers will put clients' funds into sensible, low-cost products like index ETFs, and insulate clients from insidious behavioural biases. This is an excellent outcome for most investors, who may rest assured they are no longer the patsy in a zero-sum game.

Of course, institutions take this one step further. Not only do they protect against their own biases, they actively harvest the opportunities created by others' errors. This is the difference between "winning" and simply "not losing". While access to such strategies has been limited to institutions for many years, there is no insurmountable obstacle to individuals accessing the same.

When Rayliant Global Advisors acquired Henderson Rowe in 2018, it did so with the express purpose of helping to bridge the institutional-retail gap by introducing institutional-quality solutions to the UK private client market. This is consistent with the vision of Rayliant's founder and Chief Investment Officer, Jason Hsu, who has a long history of investor advocacy. As a result, Henderson Rowe is now offering some of the most rigorously researched strategies available on the retail market – strategies developed, monitored and updated by the same globally renowned research team that builds investment programs for some of the world's largest institutions.

[1] As an aside, the United States stock market is currently 95% institutional. If you, as a retail investor, are not sure which of the investors in the U.S. market is the "patsy", well .... it might be you.

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Stefan is an Investment Manager at Henderson Rowe, responsible for helping HNW individuals and business leaders protect and grow their wealth by providing investment solutions tailored specifically to their needs. Stefan was named in Citywire Wealth Manager's UK 'Top 30 under 30' class of new wealth talent in 2017.

Before joining Henderson Rowe in 2016, Stefan had five years' experience in investment banking, working in corporate finance teams at Deutsche Bank and PwC, where he won an individual excellence award. He has provided strategic advice to a number of FTSE 100 & 250 companies and helped execute more than GBP500 million worth in equity market transactions.

Stefan has competed at county level in athletics, football and golf, and plays rugby at an international and semi-professional level. In addition, he has been a volunteer for several years caring for individuals with learning difficulties and supports Wooden Spoon and a number of other charities.

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