# Outside the Flags

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# Discipline: Your Secret Weapon

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**Working with markets, understanding risk and return, diversifying and portfolio structure – we've heard the lessons of sound investing over and over. But so often the most important factor between success and failure is ourselves.**

The recent rocky period in financial markets has brought to the surface some familiar emotions for many, including a strong urge to try to time the market. The temptation, as always, is to sell into falling markets and buy into rising ones.

What's more, the most seemingly "well-informed" people – the kind who religiously read the financial press and watch business television – are the ones who feel most compelled to try and finesse their exit and entry points.

This suspicion that "sophisticated" investors are the most prone to try and outwit the market was given validity recently by a study, carried out by London-based Ledbury Research, of more than 2,000 affluent people around the world.[1]

The survey found 40 per cent of those questioned admitted to practising market timing rather than pursuing a buy-and-hold strategy. Yet the market timers were more than three times more likely to believe they traded too much.

"On the face of it, you might think that those who were trading more actively would be more experienced, sophisticated and able to control themselves," the authors said. "But that seems not to be the case – trading becomes addictive."

This perspective has been reinforced recently by one of the world's most respected policymakers and astute observers of markets – Ian Macfarlane, the former governor of the Reserve Bank of Australia and now a director of ANZ Banking Group.

In a speech in Sydney[2], Macfarlane made the point that the worst investors tend to be those who follow markets and the financial media fanatically, extrapolating from short-term movements big picture narratives that fit their predispositions.

"Most people experience loss aversion," he said. "They experience more unhappiness from losing $100 than they gain in happiness from acquiring $100. So the more often they are made aware of a loss, the unhappier they become."

Because of this combination of hyper-activity, lack of self-control and loss-aversion, investors end up making bad investment decisions, Macfarlane noted.

These behavioural issues and how they impact on investors are well documented by financial theorists. Commonly cited traits include lack of diversification, excessive trading, an obstinate reluctance to sell losers and buying on past performance.[3]

Mostly, these traits stem from over-confidence. Just as we all tend to think we are above-average in terms of driving ability, we also tend to over-rate our capacity for beating the market. What's more, this ego-driven behaviour has been shown to be more prevalent in men than in women.

[1] 'Risk and Rules: The Role of Control in Financial Decision Making', Barclays Wealth, June 2011

[2] 'Far Too Much Economic News for Our Own Good', Ross Gittins, Sydney Morning Herald, June 13, 2011

[3] Barberis, Nicholas and Thaler, Richard, 'A Survey of Behavioral Finance', University of Chicago

A study quoted in *The Wall Street Journal*[4] showed women are less afflicted than men by over-confidence and are more likely to attribute success in investment to factors outside themselves – like luck or fate. As a result, they are more inclined to exercise self-discipline and to avoid trying to time the market.

The virtues of investment discipline and the folly of 'alpha'-chasing are highlighted year after year in the survey of investor behaviour by research group Dalbar. The latest edition showed in the 20 years to the end of December 2010, the average US stock investor received annualised returns of just 3.8 per cent, well below the 9.1 per cent delivered by the market index, the S&P-500.[5]

What often stops investors getting returns that are there for the taking are their very own actions – lack of diversification, compulsive trading, buying high, selling low, going by hunches and responding to media and market noise.

So how do we get our egos and emotions out of the investment process? One answer is to distance ourselves from the daily noise by appointing a financial advisor to help stop us doing things against our own long-term interests.

An advisor begins with the understanding that there are things we can't control (like the ups and downs in the markets) and things we can. Some of the things we *can* control including ensuring our investments are properly diversified – both within and across asset classes – ensuring our portfolios are regularly rebalanced to meet our long-term requirements, keeping costs to a minimum and being mindful of taxes.

Most of all, an advisor helps us all by encouraging the exercise of discipline – the secret weapon in building long-term wealth.

[4] 'For Mother's Day, Give Her the Reins to the Portfolio', Wall Street Journal, May 9, 2009

[5] '2011 QAIB', Dalbar Inc, March 2011

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