

Less is probably more

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The amount of information we have access to via the Internet is truly astounding. With numerous investment opinions, newspapers, magazine articles and lots of other analyst reports; does all this information equal knowledge? Do you believe that in order to generate handsome returns, you need to know more than everybody else?



"I don't have an answer, but you've sure given me a lot to think about..."

know, overconfidence is one of our greatest enemies as it leads us to invest larger portions of our capital without the appropriate diversification. Also, it makes us hang onto bad investments when one should have sold out a long time ago.

A few case studies provide us with valuable insight to human behaviour

A case-study in 1965 by Stuart Oskamp evaluated judgments and overconfidence. Oskamp investigated whether psychologists' confidence in clinical decision-making were justified. The study wanted to prove two things about psychologists as they study more information about a patient:

- That their confidence increased, but
- the accuracy of their conclusions about the case quickly reached a ceiling

The study basically proved that the accuracy of their diagnosis did not increase with more information, but that their confidence increased steadily and significantly. Stuart observed that the psychologists may frequently form stereotype conclusions and were reluctant to change their conclusions as they received new information.

In another study behavioural economist, Paul Slovic in his 1973 paper, "Behavioural Problems of Adhering to a Decision Policy" offered valuable insight into the importance of investor discipline. His study provided experienced bookmakers a list of 88 variables on the past performance of a horse (number of winnings, jockey weight, experience, age of the horse etc.).

Each bookmaker was then asked to rank the pieces of information by importance. Bookmakers were then given data for 40 *past races* and asked to rank the top five horses in each race. In order to do this, each

This is what many of us believe and I looked for studies to confirm the notion, but I could not find any. In fact, the case studies confirmed the exact opposite. Even worse, the studies found that as the amount of information increased, *it increased our confidence rather than accuracy.* And as any investor should

bookmaker was given data they selected as most important in increments of 5, 10, 20 and 40 variables. Just like the previous study the results were not what you would expect. The accuracy started out at just over 15% and increased marginally as a number of variables increased. However, going from 20 to 40 variables, *accuracy decreased to below the point where it started with only 5 variables.* The conclusion here; more is probably less. Now you might ask what does this have to do with investing?

In another study by Fred Davis, Gerald Lohse and Jeffrey Kottemann published in 1994, called "Harmful Effects of Seemingly Helpful Information on Forecasts of Stock Earnings", the research found (as in the case studies above) that both relevant and irrelevant information *significantly increased the forecast error* of MBA students whom previously worked in the investment industry. In their course about advanced financial statement analysis, these students were asked to forecast the earnings of 15 different companies as well stating their own confidence-level when making these predictions. Interestingly, during this study the confidence levels of the students increased from 56% (when they had only basic information) to 64% when they had the basic and additional relevant information.

So what does this mean?

Below are a few key points:

- All the case studies involved human predictions. Predictions are inherently flawed because we cannot "know" the future
- Working through lots of information could be a daunting task. Sometimes we think that more information and research leads to better decisions with the optimal outcome. Apparently it is not the case
- Further, less confidence is a good personal attribute. We should rather be aware of the unexpected events than trying to control them (natural disasters, wars, terrorist attacks, the economic environment etc.). It is impossible to make predictions about such events
- Investors might want to consider a checklist (in their recent newsletter Allan Gray had a good example of such a checklist). This is a proven method in order to manage a decision-making process. This technique is used by global aviation standards and during medical procedures (where human lives are at stake). Investment checklists should hone in on no more than 5 to 10 important factors. The approach could substantially reduce the time we spend on research, but it will also help us to focus on the aspects which requires our attention
- A good plan and process provides for structure in order to tackle the investment problem

At Afrafin we aspire to identify the important factors and distil information to its essence. Hence, it is important to work with an investment professional with a proven investment process. We have done that in collaboration with Finsolnet and our associates. It is a sound framework from where we want to manage our investment decisions. In this manner we can (to a large extent) control the outcomes of our portfolios.