FINANCIAL POST

Saturday, July 14th, 2012

Intuition won’t help you make money

Michael Nairne, Serious Money

Illustration by Chloe Cushman

Have you ever been on the receiving end of an investment pitch? More often than not, the sales story is proclaimed in glowing terms such as – this is a “world class” manager who has consistently achieved “best in class” performance. The piece de resistance is typically a table comparing the recommended manager’s top drawer returns over the past three or five years to that of his or her peers.

The evidence presented may seem compelling. Regrettably, investors are ill-equipped to assess it because of a common cognitive bias that behavioural finance experts call “insensitivity to sample size.” Simply put, investors (as well as many advisors) are prone to reaching conclusions based on insufficient evidence from too limited a time period. Remember that a manager’s recent performance is really just a sample of what their long-term performance will eventually be.

In actuality, the smaller the sample time period, the greater the impact that luck has on a manager’s results as opposed to skill. Statistically, it usually takes well in excess of a decade of returns to reach a conclusion with any confidence that a manager is actually skillful rather than simply lucky. “Best in class” over short time periods is mostly comprised of “lucky in class.”

Investors are not alone in their predisposition to generalize incorrectly from small sample sizes. Nobel Prize winner Daniel Kahneman and his colleague Amos Tversky, who were at the forefront of establishing behavioural finance as a branch of economics, found that even statistically schooled psychologists

overestimate the reliability of findings based on small sample sizes. From their years of research, they concluded that people often have faulty statistical intuition.

Take for instance the following three sets of results of a coin that was tossed six times in a row – H stands for the coin landing on heads while T is when it landed on tails. Which of these three sequences was least likely to occur?

1. HHHHHT 2. HTHTTH 3. TTHTHH

Many people believe that the first sequence HHHHHT was the least likely. The other sequences, which appear more random, are judged as having been more likely. The reality is that if you flip a coin six times, you end up with one of sixty-four different individual sequences. The above are three of the possible outcomes and each has an equivalent chance of occurring.

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Our conception of randomness is that it is disorderly and haphazard. Yet, in small samples in particular, this is not always the case. Chance alone explains more persistent outcomes than we intuit. Hence, a manager who outperforms his or her peers for five years in a row is glorified as "world class" because we have a hard time putting this down to mere luck.

Many people also believe in the "hot hand" phenomenon – an athlete who is on a winning streak will be more likely than usual to score on their next attempts. In one survey, 91% of fans believed that a basketball player has "a better chance of making a shot after having just made his last two or three shots than he does after having just missed his last two or three shots." Yet, in a classic study of basketball players, the "hot hand" turned out to be a myth. The chance of making a shot was unrelated to how many previous shots in a row had been either made or missed – a player's overall shooting percentage was a much more accurate guide.

Yet, people believe in the "hot hand" phenomenon in investing as well as sports. Numerous studies have demonstrated that investors chase performance by piling into recent winners and firing recent losers. Morningstar calculated that poor timing decisions cost fund investors 1.5% annually from 2000 to 2009. And it's not just retail investors who exhibit this predilection. Several studies have found that supposedly "sophisticated" hedge fund investors also chase performance.

Contrary to what we might like to think, our intuition is an unreliable guide when it comes to selecting active investment managers. Most investors would be better off sticking to a diversified mix of index funds.

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