# How to invest in equities and stay sane

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*Edward Hocknell is a partner with Edinburgh-based Baillie Gifford, where he has responsibility for North American institutional clients. The firm co-manages three Vanguard funds: Global Equity, Growth Equity, and International Growth. Mr. Hocknell, who joined Baillie Gifford in 1984, is planning to retire later this year. Vanguard asked Mr. Hocknell to distill key lessons of his nearly 30-year career.*

Life is more secure now than it has ever been. Uncertainty has been reduced to levels that previous generations would find incredible. Their lives were plagued (literally) with disease, famine, war, floods, religious manias, and social upheavals. No wonder the ancients erected massive temples and performed endless sacrifices. It was all an effort to reduce the terrifying uncertainty of life.


Edward Hocknell

We are lucky—on the whole. In the modern world, risk has been squashed and repressed wherever it appears. The big exception is in our savings, which for many of us is now the riskiest part of our lives. When we try to preserve our wealth, we immediately become medieval peasants, helpless victims of an implacable fate. Two hundred years ago, Nathan Mayer Rothschild, the greatest banker of his day, said that it was ten times harder to preserve wealth than it was to make it in the first place. Not much has changed.

Unfortunately, we have to take risks. We have no choice, because the cost of not doing so has become immense. The entry fee to safe havens is prohibitive. Bond markets are behaving like an insurance salesman who wants to charge you more to insure your house than it would cost to rebuild. Safety guarantees loss.

If we want a reasonable prospect of real returns, we have to consider investing a part of our portfolios in equities; and that means having to cope with uncertainty. As the economist John Maynard Keynes put it in the 1930s: "The modern organisation of the capital market requires for the holder of quoted equities much more nerve, patience and fortitude than from the holder of wealth in other forms." My purpose in writing this piece is to instill in you, Dear Reader, that Nerve, Patience, and Fortitude. The evidence is clear: It is worth it—and, anyway, we have no choice.

It seems to me that the greatest enemy of successful investment is "Events." We are willing or unwilling participants in an endless parade of happenings. Being human, we continuously try to integrate them into our worldview—but there are too many events for us to treat them critically or test them for relevance. With our wealth at stake, we adopt a semiconscious policy of worrying about as much as possible, and discounting as little as we can—especially if it sounds alarming. There is plenty of academic evidence for this. It is best summarized in Daniel Kahneman's excellent book *Thinking, Fast and Slow*. He shows how we instinctively default to the most recent or striking piece of evidence, and that our urge to leap to conclusions overwhelms our better, rational

selves.

Modern media make the problem much worse, of course. "News" is crafted to grab our attention; it is not created spontaneously by the world. It is said that in 1936 a BBC announcer solemnly announced over the wireless: "Good evening. It is six o'clock. There has been no news today." Those days are long gone.

So, if news and events are our enemies, how do we cope with them? The first step is to regard them with the suspicion they deserve, and to be more discriminating in how we react. From the investor's point of view, most events can be put into one of three categories: a large proportion of them are simply irrelevant, even though they may look vital and pressing; some are misleading, sending us haring off in the wrong direction; but some are boring, underreported—and very helpful.

The rest of my comments here provide examples of all three types of events, in the hope that it will help my fellow investors make some money and ignore the siren calls enticing them onto the rocks.

### The Irrelevant

Most financial news is irrelevant to our personal situation and can be safely ignored. Especially pointless are the frequent predictions of things that cannot be predicted. For instance, the forecasting records of even the best economists are very poor. We know this, but we still listen to them. We are like ancient Romans, who peered at chickens' livers before every battle to see who would win. We would be better off assuming that the economy does okay most of the time. Experiments show that in complicated matters, reversion to the mean is a better tool for prediction than listening to experts.

Similarly, the huge effort devoted to interpreting short-term market movements is largely pointless. The market is not a person; it does not have reasons or intentions. Its wanderings are the residual of countless opposing forces. It is not "trying to tell us something." Its meanderings may well provide us with opportunities to buy or sell, but it is much easier to behave rationally if we do not believe that a fall in prices betrays some hidden horror. Similarly, a rise in prices does not mean that Santa Claus is on his way.

A great deal of political, social and global reportage is irrelevant to us too. We are trying to be good investors, not emperors. We are not responsible for the big picture; we only have to buy what we really like. Very often a story will draw us in. We become "experts" on matters such as Greek public finance, which held no charms for us before, but which assume a disproportionate importance in our minds because we keep hearing about it. We are unwilling to write off this tediously won knowledge, so we think it must be important.

My point is not that everything is irrelevant, but that most investors are too exposed to random buffetings by forces that have no more influence on their portfolios than the gale outside their windows (this is written in Scotland). They should wrap themselves in a healthy skepticism to keep from being blown off course.

### The Misleading

Being somewhat contrarian, having a preference towards "leaning against the wind," as Keynes put it, is a characteristic of all good investors. This can make them difficult at home—they need understanding wives and husbands—but it helps them make money.

For the contrarian, nothing is more exciting than a misleading news item.

Good news is routinely presented as bad. For example, China's decision to raise rates to combat inflation was generally received badly. But surely inflicting pain in that way was exactly the right thing to do? Then, too, Amazon is happy to defer profits by investing heavily today. Is that really bad news? It's all a matter of having a sensible time scale. It is right to take some pain now if the eventual consequence is positive. The crisis in Europe has been a perfect example of this. Imposing Germanic fiscal discipline on a whole continent was always going to be a gradual, lengthy process. The point is that we are heading in the right direction, but almost all commentators focus on how painful each step is.

Occasionally things are worse than they look, but this mostly happens only in times of bubbly exuberance. The most obvious examples come from the financial sector. Banks tend to write off all the bad loans they can, but this has the perverse consequence that when times are really bad and their balance sheets are weak, banks often refrain from writing off junk loans and consequently report excessive profits. These profits are really a sign of weakness. An increase in write-offs and a rise in bankruptcies are signs that the healing process has started.

The moral here is that we should question the conventional interpretation put on the news, especially bad news, which typically gets a wider airing in the media than the good variety. If you are feeling particularly fed up with your investments, ask yourself this: If I were a historian of the future looking back over the grand sweep of financial history, what would the really great buying opportunities of history have felt like at the time? The answer is, "Pretty grim." It is always darkest before the dawn, and the successful contrarian knows how misleading conventional opinion can be.

### The Ignored—and Really Useful

I am not arguing that the successful investor should ignore everything and hide away from all worldly contact: No one admires the investment skills of the Desert Fathers, early Christian hermits. The point is that the world *as it is presented to us* is misleading, unsettling, and deeply unhelpful from an investor's point of view. We should be aware of this bias and remember that the really useful news is often ignored.

The simplest form of general ignorance takes place when facts arise that do not fit the conventional story. The fall in Italian long-term interest rates has been resolutely ignored by those who confidently predict a Euro disaster; the facts do not fit the story. Even market prices can be a better indicator than economic statistics, if the two persistently point in different directions. And the popularity of the incumbent political leader gives you a better reading than most official measures about how well an economy is performing.

The news we are fed has a strong negative and sensationalist tilt. As the American historian David Landes has pointed out, ultimately the only satisfaction the pessimist has is to say, 'I told you so.' The optimist is always on the lookout for the right kind of news. *On the whole, things work out in the end because people adapt their behavior*. This is something that conventional analysis has a big problem with: It presents a static picture of a world in which unsustainable behavior is always extrapolated until we run off the edge of the cliff. In the real world, people just do something else or invent something. The extrapolation fallacy is especially common in financial matters. It is obvious that

America is never going to run out of dollars, any more than a man with a functioning spigot will run out of water. The naive extrapolators cannot see this.

Conventional news ignores the benign adaptations that help us survive, because they are gradual and quiet. This is especially true of our responses to price signals—perhaps because, on the whole, the news media find companies opaque and hard to understand. Investors would be well-advised just to assume that big price changes will always lead to changes in supply and demand, and to look for the early evidence for this in companies' behavior. The most glaring example of this is America's imminent self-sufficiency in hydrocarbons, and the discovery of huge new oil fields in Brazil, Canada, and Australia, combined with a sharp increase in the efficiency of energy use. These changes are all the result of the human energy released by high oil prices over several years, but the massive implications are only gradually being recognized.

Technological change is underplayed too, because its consequences are also gradual. To take one example among many: We have barely begun to understand the implications of the internet for a wide range of service industries. Can main streets and malls survive in anything like their current form? Do professional services have to be carried out in high-wage countries? Do we have to travel to work? No specialized technological knowledge is needed to play this game: The inventions that set these changes in motion were made years ago.

### The Lessons

- Obsession with events is the enemy of prosperity and sanity.
- Don't take the news too seriously – it's mostly irrelevant.
- Bad news is often good—be somewhat contrarian.
- Supply and demand works—eventually.
- Technology changes the world—eventually.
- Stay optimistic.

If all else fails and you feel the weight of events pressing too hard; if you are under pressure to make a decision you know you will regret, there is only one answer: travel. Take a vacation somewhere without broadband. When you eventually return, you will find that the events that oppressed you have passed by and been forgotten.

**Notes:**

- All investments are subject to risks, which may result in the loss of principal. Foreign investing involves additional risks including currency fluctuations and political uncertainty. Stocks of companies in emerging markets are generally more risky than stocks of companies in developed countries. Investments in bond funds are subject to interest rate, credit, and inflation risk. Past performance is no guarantee of future results.
- The views expressed by Mr. Hocknell are not necessarily those of Vanguard.

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