Optimism bias and what it means for investors

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MARRIOTT
INCOME SPECIALISTS
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Humans are hardwired to be optimistic rather than realistic. Essentially, this means that we underestimate the chance of bad things happening to us (such as losing a job or contracting a dread disease) and we overestimate the chance of good things happening (like how successful our children will be or how long we will live). We only have to look at the queues at the Lotto kiosks on a Saturday afternoon to know about this.

It is the human condition to believe that the future will be better than the past: that life will be peachy. We are hardwired to behave in this way and we need to believe in a positive outcome in order to pursue our goals. If we did not envisage success, we would not attempt anything new; we would stifle our own potential. We also filter the past, viewing it in a more positive light – we end up believing that "even the bad times were good" which, again, ensures that we move forward.

Incidentally, people with mild depression have been shown to be relatively accurate when forecasting future events and this has been attributed to them seeing the world as it actually is. They see the world realistically, rather than optimistically.

So, although we need to be optimistic in order to survive life, at some point this optimism can be detrimental, leading to disastrous miscalculations. For example, we tend to have fewer health checkups, we don't save sufficiently to enjoy a comfortable lifestyle in retirement, or we bet the farm on an unsuitable investment.

Optimism bias means that investors are too positive

What this optimism bias means for investments is that we are overly positive about the extent to which our investments will perform. By way of example, if we were to look back 15 years, it is unlikely that we would have found anyone who would have said that the equity markets in the US, the UK, Europe or Japan would not have increased in value by now.

The reality is that these markets have been static for a decade and a half.

Closer to home, in the South African unit trust industry, we have some 2 million investors and 473,000 accounts in General Equity Funds. In the ten years to December 2012, only 28% of the accounts outperformed the average and 72% showed a return below the average. If you had selected a unit trust at random, you would have had a 50% chance of outperforming the average and a 50% chance of underperforming, however this was certainly not the case. Why?

The reason is probably a result of the poorest performing funds having been the best performers over the 10 year period 1997 to 2007, causing many investors to have chosen these funds. Maybe choosing the best performing fund today is a function of pure optimism and will not necessarily lead to the desired outcome. Marriott suggests that a more successful approach is to look more closely at what the fund is invested in and base that decision on how the underlying securities are likely to perform.

Marriott follows an income-focused investment philosophy. This means that we seek those investments which offer a reliable income stream at an acceptable yield: we will not overpay for that income stream.

In managing our assets, we filter out the erratic performers – companies which have volatile earnings, like those in the resources sector or in cyclical industries. We then focus on companies which produce steadily growing returns; those which are less likely to give investors nasty surprises. In this way, we are able to calculate with a reasonable degree of certainty, the income that the investment will produce in 15 years' time. It is thus possible to have a realistic idea of the value of the investment in 15 years' time.

This is useful because it removes the inherent optimism that leads to bad investment decisions and enables one to plan effectively.

An example of a great company for investment is Johnson & Johnson. It is a global manufacturer and distributer of pharmaceuticals, medical supplies, and dozens of everyday brand name consumer products. It has been in business since 1887. We all grew up with Johnson's Baby Powder and Johnson's Baby Oil. The company's consistent performance has enabled it to generate an exceptional track record of growth that few, if any companies can match: 29 consecutive years of earnings growth; and 50 consecutive years of dividend increases.

This is in a highly defensive industry – there will always be demand for J&J's products and brands despite the vagaries of the macro environment. It sells basic necessities worldwide, has a strong balance sheet and in many ways is distinctly independent of its home economy. It tends to fare well in both recessionary and growth phases of the economic cycle and is seldom at the mercy of a new idea, trend or fashion. Its product range is an everyday necessity, with market dominance a function of its brands.

Another such company is Unilever, the world's third-largest consumer goods company, which provides products that are used daily in homes around the world. With an impressive array of over 400 brands, Unilever touches most of our lives in some way in the course of a day. Unilever is multinational with operating companies and

factories on every continent except Antarctica. In addition, as consumer products, repeat purchases drive profits enabling the company to produce solid, growing dividends.

A final example is that of Spar, South Africa's third largest food retailer. Over the past 40 years, domestic food inflation in South Africa has averaged 11% p.a. With food being one of our most basic necessities, Spar has been able to pass on food price increases without sacrificing margins or turnover, and boasts an impressive dividend track record.

In the words of Warren Buffet, "I look for businesses in which I think I can predict what they're going to look like in ten to fifteen years' time". We couldn't agree more.

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About Marriott Asset Management

The Income Specialists aim to reduce financial anxiety of retired investors by offering Solutions for Retirement, using an Income Focused Investment Style which produces reliable and consistent monthly income.