Survival of the Fittest

[South Africa Lessons on Investing]

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Beauty Abounds

Your editor had the great good fortune this quarter to spend some time in South Africa, a land whose natural beauty is as impressive as the intellectual curiosity and good humor displayed by the group of South African executives whom a group of visiting Americans had the privilege of addressing. The visitors were money management types, the most distinguished of them being Meir Statman, one of the leading figures in the burgeoning field of behavioral finance. As noted in the lengthy dialogue on behavioral finance that we published in our *Quarterly Report* dated March 31, 1996, Dr. Statman and his colleagues in this relatively new discipline focus their attention not on what investors do but **why**. This is fascinating stuff, especially for the eager but relatively inexperienced South African pension officers who filled the stands — but even for a jaded American investor who himself has fallen into most of the mental traps that Dr. Statman identified for his listeners. Your editor was also fascinated by the splendid wildlife seen on the group's visit to a game reserve abutting Kruger National Park in northwestern South Africa. Indeed, it was tempting to draw parallels between what Dr. Statman and other speakers had to say at the pension officers' conference in Cape Town and what we wide-eyed tourists espied on the game reserve.

Law of the Jungle

Herewith a list of some of the parallels that came to mind as your scribe reflected on his visit to South Africa. (Americans returning from SA have ample time for reflection, because it takes longer to travel between the two republics than it does for one of Africa's pulchritudinous pachyderms to gestate.)

* Safety in numbers. Although our group did not actually witness a "kill," we did **hear** two lionesses corner an impala that had become separated from its compatriots, and we then watched as a very hungry male lion chased the females from their kill and dined alone in regal splendor. (With some exceptions, South African business chieftains seem far more respectful of women than their male counterparts in the animal world, which bodes well for both society and the economy.) Obviously, for impalas as well as many other species of herbivores living in the African wilds, it is dangerous in the extreme to wander too far from the crowd.

* Overcoming overconfidence. The same principle applies to the many investors (indeed, to virtually all investors, according to Statman) who lack the instincts or tools to survive apart from the pack. No impala in its right mind would dare attack one of Africa's big cats, because animals lack the overconfidence that causes many humans to overestimate their own abilities, especially with respect to forecasting. If this little homily sounds like a paean to indexing, it is, because as Statman and other behavioral finance

experts have demonstrated convincingly, overconfidence is the root cause of several recurring mistakes that many investors tend to make. Many investors (1) adopt unrealistically high return objectives (2) chase recent winners (be they individual securities or commingled funds) or (3) do both, causing them to bail out of potentially winning strategies or positions at the first sign that their lofty goals may not be met. They would be much better off lowering their sights, if not with all of their investable assets then with a prudent portion of them.

* Expecting the unexpected. As active US stock managers discovered anew in 1998, truly wild things can happen in financial markets. (See page 22 of this quarter's TIFF Funds Quarterly Report for a discussion of the US stock market's unprecedentedly narrow breadth last year — an unexpected development that caused some TIFF Members whose return aims were not satisfied by even double-digit returns to shift their funds into the rapidly rising S&P 500.) Truly unexpected things can happen in the African wilds also, as a park ranger made clear when he related the account of a pack of hyenas that recently had attacked and killed a lion. In addition to being perhaps the only instance of the Disney company accurately depicting reality (recall the scene in The Lion King where hyenas corner a lion), the ranger's tale teaches investors that if enough craven characters band together, they can triumph over even markedly superior creatures. Surely there are some professional investors who cannot comprehend how folks who simply tossed their money into just one no-brainer asset subclass (i.e., large US growth stocks, as defined by the S&P 500) could have achieved higher returns throughout the late 1990s than putative experts who favored state-of-the-art multi-asset portfolios. Lest any readers conclude that we think S&P 500 indexers are dumb as hyenas, let us add that hyenas are actually much more impressive than their bad p.r. implies: they are highly sociable animals that exhibit strong bonds between clan members, as well as advanced parenting and hunting skills. That said, they are as pleasing to look at as the relative performance of most actively managed US stock portfolios in the late 1990s. Talk about ugly.

* Sloth is a virtue. Numerous studies indicate that most investors are perversely hyperactive, making far too many changes in their portfolios far too often. Indeed, with the possible exception of a handful of exceptionally talented (or lucky) hedge fund managers who have achieved stellar results through enormously high portfolio turnover, most investors seeking to earn outsize returns would have a much better chance of achieving their goals if they lengthened both their investment time horizons and their holding periods. (Many investors say that they're "in it for the long term," but their actions belie such rhetoric.) Surprisingly, the exemplar of patience in the African wilds is the crocodile, a creature whose reputation as an insatiable carnivore conflicts wildly with its actual eating habits. Although we would counsel against taking a swim with a croc nearby, even one that has recently eaten, crocodiles actually eat very infrequently, with some mature crocs killing another living thing to satisfy their hunger just once every 12 to 18 months. In our judgment, 12 to 18 months is far too short a time period for investors to do anything prudent with their money other than to park it in high quality, short-term bonds, but many investors can't resist doing something even if their longer-term needs are being met. Crocodiles display the same character flaws, of course, pouncing on unsuspecting creatures whose gyrations disturb a croc's karma even if the reptilian beast has a reasonably full stomach. Substitute mutual fund investors for crocodiles, mutual fund managers for unsuspecting creatures, occasional bouts of underperformance for

gyrations, and double-digit returns for reasonably full stomachs, and one can see that the parallels between lagoon life in the African wilds and the professional life of the typical US stock manager in the late 1990s are close if not perfect. [1]

* Risk is in the eyes of the beholder. We have discussed this cardinal principle of investing elsewhere (Members interested in knowing where and why should zap a note to David Salem), but it merits comment here in connection with perhaps our most unnerving moment in Africa. No, it was not the moment your editor was asked by a roomful of still-angry executives to defend American universities' decision to divest their endowments of South Africa-related stocks. (More on this anon.) Rather, it was the moment that an impossibly large male lion came within two feet of this writer, who was sitting anxiously but impassively in an open vehicle. Our guide promised that we would be safe so long as we did not stand up: lions that live on game reserves become accustomed to the shape of the reserves' various vehicles and will not attack what is clearly edible material (i.e., the gawking tourists sitting but a few feet away) so long as its superficial appearance suggests a potential reward that is inadequate in relation to the effort required or the perceived risks. Little did the lion in question know that with one swift move of its massive head it could have captured at least a robust appetizer, if not a full meal. The lion perceived our close encounter as potentially unrewarding, if not risky, but the opposite was closer to the truth. And at least one gawking tourist perceived the encounter as excessively risky in relation to the potential reward. (A blurred photo of a lion taken from just a few feet away is inferior to even the cheapest store-bought postcards if the photo is taken with trembling hands!) Of course, such shockingly intimate encounters between man and beast would become impossible if humans began firing on lions from their vehicles, or if the lions began attacking their camera-laden admirers. Happily, it has been many years since any serious blood has been shed as a result of such close encounters, just as it has been many years since investors in large capitalization US stocks have suffered a serious impairment of their capital. Not surprisingly, the average investor (individual as well as institutional) has begun moving closer and closer to a fully invested stance, not via a globally diversified mix of stocks, bonds, and other asset types, but via a US- and stock-centric portfolio. One wonders what will happen if a creature that has acted so benignly for so long (i.e., the large cap US growth sector) suddenly begins to display dangerous tendencies.

Law of Unintended Consequences

As noted above, your editor was put in the unusual position of having to defend American universities' decision during SA's apartheid era to divest their endowments of SA-related stocks. This was ironic, to say the least, because some money management professionals (your editor included) wondered at the time and indeed still wonder whether divestment was truly in the best long-term interests of black South Africans. It came as a bit of a shock to hear so many well-informed and intelligent South Africans, including numerous blacks, argue that divestment has done more long-term harm than good to the average black South African. Prior to this recent visit to SA, your editor's view was that divestment played an essential role in bringing apartheid to an end — not primarily through the pressure that it exerted on multinational manufacturers to pull out of SA lest their stock prices sag, but rather through the intolerable pressures that it exerted on multinational banks. As most readers are aware, the multinational manufacturers that pulled out of SA had no trouble at all selling what were for them almost immaterially small operations to eager buyers from Germany, Japan, and other countries with far less enlightened labor policies. But it was not until leading US banks began to seriously curtail their lending that white South Africans began to seriously consider relinquishing control. Divestment may have hastened the transition to majority rule, but it also arrested the development of the necessary critical mass of experienced black managers, and many of the executives who attended the Cape Town conference expressed fears that the dearth of experienced blacks at the middle and senior levels of South African managements will cause things to get worse before they get better for the average South African, black or white. This visit to South Africa was a bully experience, but it did not make this writer bullish on South Africa, at least over the near and medium term.

Endnote

1. A crocodile can live up to 160 years. Imagine reaching the age of 160 and being able to recall almost every meal! If there is an analog to such prodigious feats of memory in the investment arena, it is perhaps the proverbial life trustee of an endowed institution who recalls perfectly every decision that its investment committee has ever made and opposes strenuously any proposals that would have the institution commit funds to strategies that failed when tried previously. It will be many years indeed before some institutions that made an initial foray into emerging markets when they were soaring in the early 1990s summon the courage to wade back into such waters again, despite the compellingly low valuations at which some well-managed emerging market firms now trade.