

With a Steady Hand

Essays on Long-Term Investing

Number 2

Do investors want to be cheated?

By Karl-Heinz Thielmann

Some months ago I had an appointment with an old friend who currently works as a consultant for institutional investors. We had not met for several years and thus we had a lot to talk about over a long lunch. I told him how I had recently founded a company with the aim of making long-term thinking more popular among investors again.

During my explanations my friend shuffled more and more nervously around on his seat. And then, after a while, he burst out with, "Everything that you're saying is 100% right. However, it's no use. The clients simply do not want to know the truth." Then he told me about his concerns. Of course he would like to help his customers to achieve a better performance with a long-term investment strategy. But if he were to present an investment proposal to them that contained no complicated finance products or inscrutable mathematics, they would simply consider him unprofessional and he would lose his job. Therefore, he doesn't see his task as providing an optimum investment strategy to his customers. Instead, he tries to prevent his clients from damaging themselves.

Some days ago a very interesting study by the "Center of Applied Science", a research institute belonging to State Street Bank, Boston, was published. In "The Influential Investor", 2725 investors and 603 other persons connected with the investment industry (regulators, consultants, etc.) were questioned about the behaviour of investors. The result was frightening. Obviously a prevailing number of investors systematically make the wrong decisions. This does not only concern private investors. The researchers found that institutional investors in particular tend to invest in products that have a degree of complexity they cannot cope with.

Speed Read:

- *Practical experience and recent empirical studies confirm that investors are systematically making the wrong decisions.*
- *The reasons for this are short termism, general mistrust and the overconfidence of investors.*
- *General mistrust leads to a process of adverse selection of investment advisors, because investors do not believe in new proposals or ideas. Only the hypocritical consultants who confirm preconceived views are heard. If advisors try to give independent advice they get rejected because they are regarded as generally unreliable. This leads to trustworthy consultants being replaced by dishonest ones.*
- *Reforms such as those proposed by the Retail Distribution Review in the United Kingdom may not be sufficient to reestablish trust in the financial markets.*

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Therefore they are not able to judge the risks of the products properly.

This confirmed the subjective appraisal of my friend: professional investors in particular require apparently inscrutable financial products. The longer-term performance prospects seem second-rate. However, what are the causes of this odd behaviour? The researchers of the "Center of Applied Science" also found some answers. Essentially they identified three reasons: short-termism, basic mistrust in other financial market actors and general overconfidence. According to our assessment, this has the following consequences:

1) Apparently, a basic trend towards short-term behaviour pressurizes institutional investors into permanent actionism. If they or their trustees are not constantly active in the markets, this could lead to the impression that they are missing something.

2) The fact that banks and other financial institutions have ripped off their customers with hidden fees during the past years is general knowledge now. The result of this development is obviously that many customers now generally expect their advisers to be dishonest. This has the fatal consequence that customers only accept advisers who confirm what they already think anyway. A consultant who wants to provide a new idea for his customers is not perceived as trustworthy any more.

3) Most investors - and this concerns private and institutional investors – show massive overconfidence in their own abilities to evaluate the financial markets. Investors apparently therefore require over-complicated products in particular because they can then regard themselves to be smarter than the other investors. If, however, almost everybody thinks that they are smarter than the general public, only very few are actually genuinely smart.

The growing suspicion concerning financial advisers is producing strange effects. Thus Professor Bernd Ankenbrand from Karlsruhe has conducted empirical economic research that shows that managers of hedge funds carefully select their watches when preparing for client meetings. Apparently their wristwatches are an important signal for the investors. Whereas too expensive watches suggest a rip-off, too cheap watches point towards failure. Only one watch – one which is neither too cheap nor too expensive - isn't disturbing for the customer and creates the right atmosphere for business transactions. But isn't using watches as a selection criterion for fund managers similar to judging a book only by its cover?

The basic mistrust in the finance profession is becoming a growing problem. Already in 1970, George Akerlof explained where basic mistrust leads in his famous article "A Market for Lemons", using the example of the used-car market. In general, buyers of used cars cannot judge whether their car contains hidden defects or not. So they basically mistrust used car dealers and want a price reduction. This actually results in only the dishonest dealers being competitive, because they want to sell their faulty vehicles at excessive prices anyway. However, the honest suppliers have to sell their cars at a price that is uneconomical. This leads to the honest dealers being replaced by the dishonest ones.

We currently observe a similar tendency in the financial industry. Advisers who intend to act in the interest of their customers are being pushed off the market or are resorting to damage limitation like my unhappy friend. However, the cheaters adapt their sales pitches to their customer opinions and grow their market share. But, in the long term, customers will see how they have been treated, again leading to an increase in mistrust in the financial markets.

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Should the question “Do investors want to be cheated?” therefore be answered with “Yes”? Of course not. Nobody wants to be cheated. But many investors are asking to be cheated. If an investor approaches his financial adviser or consultant with the preconceived ideas: a) “You are untruthful anyway” and b) “In general I know everything better than the others”, then there should be no surprise if they end up only dealing with swindlers. If an adviser has to support a predetermined opinion to be selected, and if the proposal of new ideas is automatically evaluated as an attempt to deceive, financial advice will be reduced to what it has actually become in many cases - to a sales effort for risky and overcharged investment products.

It also means that the reforms proposed by the Retail Distribution Review in the United Kingdom may not be enough to reestablish trust in the financial markets. They will come into effect on January 1 2013 and abolish payments from the provider of financial products to the adviser. However, this reform covers only the distribution of financial products and not the other parts of the investment chain. Suppliers of financial products, their trustees and their consultants are still not sufficiently incentivized to supply adequate information to their clients. They will remain entangled in a web of mistrust and will therefore continue to make the wrong investment decisions.

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Sources:

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Curriculum vitae of the author:

Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

LONG-TERM INVESTING Research AG was founded in early 2012 as a research unit focused exclusively on the requirements of long-term investors. It is completely independent from financial institutions and has no direct or indirect interest in selling financial products. Its aim is to provide unbiased analyses and to collect knowledge on investing that is based on the experiences of successful investors in the past as well as on the latest insights into capital market research and science. In addition, it aims to provide investors with a clear picture of the risks linked with their investments.

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