Insights into successful investing

A look at empirical studies done by academics can help enhance an investor's performance

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LAST week, Singapore Management University's SMU Sim Kee Boon Institute of Financial Economics organised a half-day seminar on "The Opportunities and Challenges Facing the Asset Management Industry in Asia".

One of the presentations was by Melvyn Teo, associate dean (research) of Lee Kong Chian School of Business at SMU, on the topic "Insights for Investors from Empirical Research".

I went through his presentation materials and found them interesting, and thought I’d share them with readers here.

Prof Teo highlighted four insights gleaned from empirical studies done by academics which could help enhance an investor's performance.

First is investor psychology. There is a big field of study called behavioural finance which tries to shed light on the numerous human biases and irrationalities when it comes to investing, particularly in stocks and shares.

Overconfidence

Prof Teo picked one: overconfidence. Overconfidence leads to overestimating, and overestimating results in higher transaction costs. High transaction costs in turn cut into returns.

A study by Barber and Odean, published in 2001, divided a cluster of investors into five groups, ranking them from the least to the most active traders. The gross returns of all the five groups that investors have to actively manage their portfolios, ie trade, in order to pre- and net return. The higher the monthly transaction costs, the lower the net return.

The average investor's net return, after accounting for transaction costs, is worse than simply putting money in the S&P 500 index fund.

My take is that the study was published in the year 2000, probably based on data before 2000. Since then, the world has changed rather drastically. For one thing, stock markets have become a lot more volatile. Increasingly, there are more believers that investors actively manage their portfolios, ie trade, in order to preserve their wealth, and also to capitalise on the opportunities to buy assets on the cheap. Getting the timing right, of course, is the proverbial holy grail in investing.

While both men and women share the overconfidence trait, men are more overconfident in their ability to make financial decisions. As such, they tend to trade more. Barber and Odean, in a paper published in 2001, said that men traded 45 per cent more than women, and the trading reduced their net returns by 2.65 per cent a year as opposed to 1.72 per cent for women.

The difference between single men and women is even more pronounced. Single men traded 67 per cent more than single women, thereby reducing their returns by 1.84 per cent per year more than single women.

The second insight presented by Prof Teo related to market inefficiencies. The theory is that the market is efficient, and that the stock price should incorporate all the information that is publicly available about that particular security. "However, investors suffer from limited attention. They are apt to purchase attention-grabbing stocks that have extreme returns, high volume and significant events," said Prof Teo, quoting Barber and Odean.

One market inefficiency noted by Prof Teo is the customerupplier links between firms. Sometimes, the market does not react immediately to the bad news announced by a stock's major supplier, or perhaps even its major customer. "Investors may ignore these economic linkages in the short term, resulting in a lagged response of supplier prices to customer price changes, and hence predictability," said Prof Teo.

And when it comes to picking hedge funds, Prof Teo's own study has found that the clever a manager is to his or her investment region, the higher the outperformance. Meanwhile, his analysis of Japan-focused hedge funds showed that hedge funds managed by native Japanese speakers outperformed those managed by non-native speakers by more than four percentage points a year. And among the non-native speakers, those who are closer to the market outperformed those further away by 2.5 percentage points a year.

Hedge fund managers’ incentive structures also matter. According to Prof Teo, portfolios of hedge funds with performance fees and high water mark significantly outperform those with no high water mark and low performance fees.

In another study, Chevalier and Ellison tried to find out if certain types of managers generate better returns. They looked at 2,029 fund-years for growth, and income mutual funds between 1988 and 1994. They found that a manager who graduated from one of the best schools would be expected to achieve an annual return which was more than one percentage point per year higher than that of a manager who attended a school of median quality.

Older managers performed worse than younger ones, while managers with MBAs earned about 60 basis points per year more than managers who didn’t.

Overconfidence

However, the superior performance of MBAs was fully accounted for when one adjusted for differences in the riskiness of the individual stock holdings. Meanwhile, a large portion of the superior performance of younger managers was attributable to their working for funds which charged lower expenses and to survivorship biases in that the poor performing managers were replaced by their firms, leaving only the better ones in the study sample.

The researchers however did find that there remained substantial performance differences between funds managed by managers from high-SAT schools and funds managed by managers from low-SAT schools which were not explained by observable differences in behaviour or by survivorship biases.

Indeed, a separate study done by Grimblatt, Khurana and Lin on mutual funds based on data from Finland showed that Finnish with higher IQs tended to have a greater participation rate in the stock market, and the higher the IQ, the better their performance.

Prof Teo’s conclusions to the audience are:

1. Beware of behavioural biases such as overconfidence and their effects on your tendency to over-trade;
2. Take advantage of mistakes that others make in the market;
3. Invest in securities that you possess an informational advantage in; and
4. Make sure that your manager is smart and well-incentivised to invest on your behalf so as to minimise agency problems.

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