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### MYOPIC LOSS AVERSION

As a slight departure from my usual month end newsletter I write this on a gorgeous day at a café overlooking Bondi Beach with 4 trading days left of the month, and not at the beginning of the new month as usual. This letter is addressed primarily to myself as a source of intellectual reinforcement, but I believe we can all take something from its message.

As a discretionary fund manager there are many times when ones market calls do not go exactly according to plan and it is during these times that we need to dig deep into our resolve, to question the basis of our research and our overall methodology and ultimately deliver on our stated objectives. Whilst the current market has moved with more persistence than I anticipated, it has by no means behaved in a manner at conflict with my overall market views. In fact what has developed over the last 6 weeks I believe is a fantastic gift for a sentiment extreme trader such as myself. The most reputable sentiment indicators are currently registering extremes above their 2007 highs with bears in extremely short supply. This combined with momentum indicators stretched to severely overbought levels paints a superb picture for an aggressive market reversal.

So let me once again re-look at the stated objectives of the Velocity Global Macro REIT Hedge Fund. The objective is to achieve a 30% annual return with a Sharpe Ratio of 1 displaying an asymmetrical return distribution over a full trade cycle of 9 - 12 months. Having a clear objective and sticking to its goals is the key to achieving success, even more so in the face of adversity. Our strategy is very clear in that we look to make outsized returns when market calls are correct and keep losses to a minimum in the event of us being wrong. We have described at length in previous letters that markets behave according to their own time line and hence we accept returns to be asymmetrical as the market doesn't respect a hedge fund managers calendar performance needs. Having reaffirmed the funds objectives and feeling calm about the current portfolio composition it will be good to analyze the financial industries short term bias which places so much pressure on short term performance, consequently at the expense of longer term performance (talk about shooting one's self in the foot).

The bias I am referring to is *Myopic Loss Aversion* ("MLA") (Benartzi and Thaler 1995) where too greater emphasis is placed on short term (myopic) performance causing investors to underweight risk and as a consequence underperform. In order to understand where the theory of MLA originated we need to take a few steps back and look at a problem Mehra and Prescott identified in 1985 called *The Equity Premium Puzzle* which questioned the quantum of the equity premium for stocks over bonds as should be explained using the classical economic paradigm. According to their analysis of +- 100 years of market data the equity risk premium which is the equity return less



the risk free rate should have been a lot lower than evidenced by the data, thus implying a far greater need for compensation for taking on market risk than a symmetrical model would suggest.

The answer to this puzzle came by way of MLA, an adaptation of the seminal work *Prospect Theory* (Tversky and Kahneman 1979), whereby Benartzi and Thaler used two of its key principles, namely *Loss Aversion* and *Mental Accounting* to clarify the problem. These two theories are huge pillars of the Behavioural Finance landscape and will need far deeper analysis, which we will hopefully get to in future letters but for now it is sufficient to say that *Loss Aversion* is the thesis that one feels the pain of financial loss a lot more than the joy associated with financial gain. *Mental Accounting* describes the way we evaluate outcomes to our decision making process, in the case of MLA it refers to the way we frame financial performance in a very narrow time frame.

With this basic framework in place let us look at the case in point. The Velocity Fund believes it takes between 9 - 12 months for it to achieve its stated objective of 30% per annum. Theory tells me and the acid in the pit of my stomach validates the theory that the more frequently I look at performance the greater the likelihood of feeling discomfort, hence the greater the probability of avoiding risk in the portfolio the very source of the funds performance. It is therefore imperative that I put aside the industries need for neatly boxed monthly returns in an effort to stay true to the funds objectives and in so doing by lengthening the funds performance evaluation in line with its objectives we will be able to at this most crucial point in the trade cycle embrace the appropriate amount of risk in order for the fund to achieve its performance goals.

By focusing on the funds last 3 months of losses and ignoring the superb performance over 15 months it is very easy to become negative and too risk averse at a time when our market research is pointing to the highest probability of outsized gains for those few mavericks committed to a market reversal. In conclusion, Bavlatsky and Pogrebna (2006) found experimental evidence supporting a process of tilting the very behaviour responsible for MLA and in so doing neutralizing its damaging effects. I believe the validation of the funds stated objectives and the emotional acceptance of the funds performance time line is a great step towards avoiding the bias of *Myopic Loss Aversion* afflicting fund managers and investors.

**Michael Berman, Ph.D.**