R.C. BROWN
investment management plc

MARKET COMMENTARY NEWSLETTER

Q3 2018

THE WORLD ACCORDING TO GLENN…….

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For some years, my wife was convinced that heaven was located within the confines of Claridge's Hotel and this knowledge was to be celebrated in the partaking of afternoon tea there. But just recently, heaven for her has moved to a hotel set in the tropical forest of central Bali, where some Leibnitz or Voltaire reading Hindu Deity has created "The best of all possible worlds". However, heaven comes at a price that even differential calculus cannot work out and so, from contemplating the infinite struggle between free will and determinism while floating in our perfect infinity pool, my mind turned to the rather more prosaic need to earn a sufficient return on capital to pay for such heavenly delights.

Luckily for me, the solution does not involve a great deal of additional effort and is to be found in the somewhat esoterically named "Myopic Loss Aversion" theory. This basically says that the equity risk premium (or the incremental return required for investing in volatile equities instead of predictable risk-free bonds) is as high as it is because, when capital allocators consider the risk/return trade off over relatively short investment periods they tend to focus on the risk of losing money and thus demand a higher potential return to compensate. But long-term investors do not need to worry so much about volatility and can focus on the benefit from compounding the incremental annual returns on their equity investments over many years. So all we have to do is lie back and rake in the higher than theoretically expected equity risk premium. Mehra and Prescott found that between 1889 and 1978, the risk premium on US equities was 6%, but the largest premium they could derive from their model (by using standard measures of risk – which are focused on volatility) was 0.35%. This difference is huge and it's worth noting that it takes 70 years for a portfolio to double if it's growing at 1%pa, but only ten years if it's growing at 7%. In a recently published Chicago Booth Research paper (number 17-33) Fama and French (of Five Factor Asset Pricing Model fame) also found that the long-term equity risk premium on the US equities was 6% between 1963 and 2016, but their data also encouragingly showed that "as the time horizon increases bad outcomes generally become less likely and extremely good outcomes become more likely". However, they also found that "the high volatility of monthly stock returns and premiums means that for the three-year and five-year periods used by many professional investors to evaluate asset allocations, the probabilities that premiums are negative on a purely chance basis are substantial, and they are nontrivial even for ten-year and 20-year periods". While Fama and French regard this as bad news we are actually quite happy to see this conclusion because, if other professional investors demand a high equity risk premium to compensate them for high volatility then we are delighted to bank these incremental returns for our clients. Remember, for us, volatility is not a complete or adequate descriptor of risk and we continue to define risk as "the chance of suffering

WHY ADVISERS & CLIENTS TRUST US

- Our portfolios are managed on an 'individual client' basis, with direct access to the Investment Manager making the decisions
- Our minimum portfolio size is only £15,000
- We have a clean, transparent fee structure free from transaction & custody charges (starting from 0.625% for actively managed portfolios)
- We have our own money, and that of relatives, invested in the same strategies as our clients
- We have our own NISA, at no additional cost, and we can manage portfolios within SIPP, SSAS and Bond wrappers
- We are here to support the Adviser with THEIR clients, as we only provide discretionary portfolio management services

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a permanent loss of capital". In short, we want to have exposure to good stocks, with growing profits, that won't go bust and to hang on to them for the long term. Of course, it is possible that the more widely the equity premium puzzle is debated the smaller the premium will become until it approaches the theoretical level. But human nature seems to be very slow to react to rational conclusions drawn from long term data, so I'm willing to bet that the actual long-term average equity risk premium remains higher than the theoretical, mathematically derived level. In a 2006 paper Barberis and Huang suggest that this is because we tend to make investment decisions using only "accessible" information without considering the context of a decision in relation to our total wealth. We should adjust our behaviour over time as we learn that we could make a better decision. However, we tend not to re-frame our thinking and the data show that the equity risk premium has remained stubbornly high.

The academic research on loss aversion is quite persuasive and experimental studies (see for example; G Fellner, M Sutter – The Economic journal 2009) have shown that Benartzi and Thaler's theory on myopic loss aversion holds up well when tested on real human beings. It seems that we really are loss averse creatures and the pain from incurring a loss is indeed greater than the pleasure from a gain of the same amount. What is worse is the finding by M Haigh and J List, published in the Journal of the American Finance Association, that traders on the Chicago board of Trade exhibit behaviour consistent with Myopic Loss Aversion but to a greater extent than students who had previously been used as experimental guinea pigs. Now I know that options traders in Chicago are likely to have a relatively short term investment horizon and that it will be important to them to preserve capital in order to make future trades but, by the sheer volume of trades made and the large number of traders making them, you would have hoped that at least some of them would not have been confused by Paul Samuelson's paper on "Risk and Uncertainty: A Fallacy of Large Numbers". To paraphrase the law of large numbers; if you repeat a gamble often enough the outcome will be close to the expected value. Thus, in Samuelson's view, it would be illogical to refuse one bet, as being too risky, but to accept a string of many similar bets. However, the only way you can take, say,100 bets is by first taking the initial one, even if the perceived risk of taking such a bet in isolation makes you want to turn it down. This is what Bernatzi and Thaler termed "myopic loss aversion" and the options traders consistently showed too high a fear of loss compared with real world data.

Significantly, a possible solution to this myopic response is to stop looking too closely at the returns on our investment portfolios. A paper by a PhD student, Maya Shaton, in 2010 showed that when the Israeli regulator changed the order in which the returns on a fund were presented there was an effect on investor behaviour. Previously the first number shown was the return for the most recent month, but post the new regulation the return on the past year was shown first. This had the effect of causing investors to shift more of their assets into equities. They also traded less often and were less likely to buy into funds with high recent returns. It would appear that although Israel has been accepted as a contributor to European culture by competing in the Eurovision Song Contest, European financial regulators do not yet want to share the ideas of the Israeli regulator and, in my view, they recently made a retrograde step when (with the

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introduction of MIFID II) we began having to report on a quarterly basis instead of half yearly. You will have seen from the first of our new style quarterly reports to clients that three of the reports each year will be kept reasonably short while remaining compliant with the regulation and the fourth report will be rather fuller and focus on longer term activity and performance. The reason for this is not just laziness on our part but is rooted in sound behavioural finance principles.

As I write this, if I look out of the window at the grey sky and damp ground, summer seems an age ago but my holiday remains in my memory as a time when I could recharge the batteries, read and spend time thinking about what I could do better on returning to work. My wife and I are now very much back at work, as a head teacher she will no doubt be looking for innovative ways to inspire her charges to achieve greatness and perhaps I should look to emulate this. So in the best Dr Pangloss fashion, as a team, we will strive to be the best investment managers we possibly can be and to deliver the best service we can.

I must apologise if my quick canter through some of the relatively recent thinking on behavioural finance seems a world away from us managing your clients' portfolios, but in truth understanding the psychology and motivation of other market participants is an important consideration in helping us decide our investment strategy. As a result of this exercise not much has changed (although I must point out that the high equity risk premium referred to is historic and was calculated for the US market, in this context "the [UK] is a foreign country" as L P Hartley nearly said and values for our market may be substantially different even though the arguments hold up) ; we still prefer equities over bonds and we still believe the US equity market is overvalued (but that some individual stocks represent reasonable value). We also still believe that Japan and Europe are attractively valued but will continue to allocate a relatively high proportion of clients' assets to UK equities because, when the time comes for them to spend their capital, they will do it in sterling and we don't want to take too big a currency risk. Finally, I should reiterate that we believe that investment is for the long term and is best suited to those who can stomach periods of high volatility and buy when markets fall.

Private Client portfolio past performance data
As at end June 2018
(FOR PROFESSIONAL ADVISERS ONLY)

Risk category		3mths	12mths	3 Years	5 Years
Cautious	**Managed Funds**	**4.51%**	**5.62%**	**20.94%**	**43.16%**
	Direct	**3.47%**	**3.17%**	**19.88%**	**39.01%**
	**FTSE Private Investor Conservative*	*2.42%*	*3.66%*	*21.23%*	*38.12%*
Cautious Balanced	**Managed Funds**	**5.23%**	**6.74%**	**25.26%**	**49.99%**
	Direct	**4.58%**	**4.74%**	**27.29%**	**47.23%**
	FTSE Private Investor Income	*3.77%*	*4.85%*	*25.42%*	*44.52%*
Balanced	**Managed Funds**	**5.93%**	**7.77%**	**30.53%**	**54.42%**
	Direct	**5.28%**	**5.59%**	**32.24%**	**54.25%**
	**FTSE Private Investor Balanced*	*4.79%*	*6.09%*	*30.26%*	*51.80%*
Balanced Growth	**Managed Funds**	**6.44%**	**8.41%**	**32.63%**	**59.31%**
	Direct	**5.82%**	**5.84%**	**32.50%**	**53.95%**
	**FTSE Private Investor Balanced*	*4.79%*	*6.09%*	*30.26%*	*51.80%*
Growth	**Managed Funds**	**6.66%**	**8.82%**	**35.15%**	**61.75%**
	Direct	**5.87%**	**5.93%**	**33.70%**	**54.02%**
	**FTSE Private Investor Growth*	*5.76%*	*7.08%*	*34.57%*	*57.84%*
Market data					
ARC £ Balanced		*2.34%*	*2.85%*	*17.76%*	*33.42%*
ARC £ Steady Growth		*3.66%*	*4.27%*	*24.61%*	*43.56%*
ARC £ Equity Risk		*5.09%*	*5.79%*	*33.51%*	*51.19%*

ARC (Asset Risk Consultants) are an industry provider of research and peer group portfolio performance reporting. ARC returns have been adjusted to a "before fees" basis

(After all underlying fund charges, but before RCBIM fees, * the benchmark is the relevant corresponding FTSE Private Investor Total Return)

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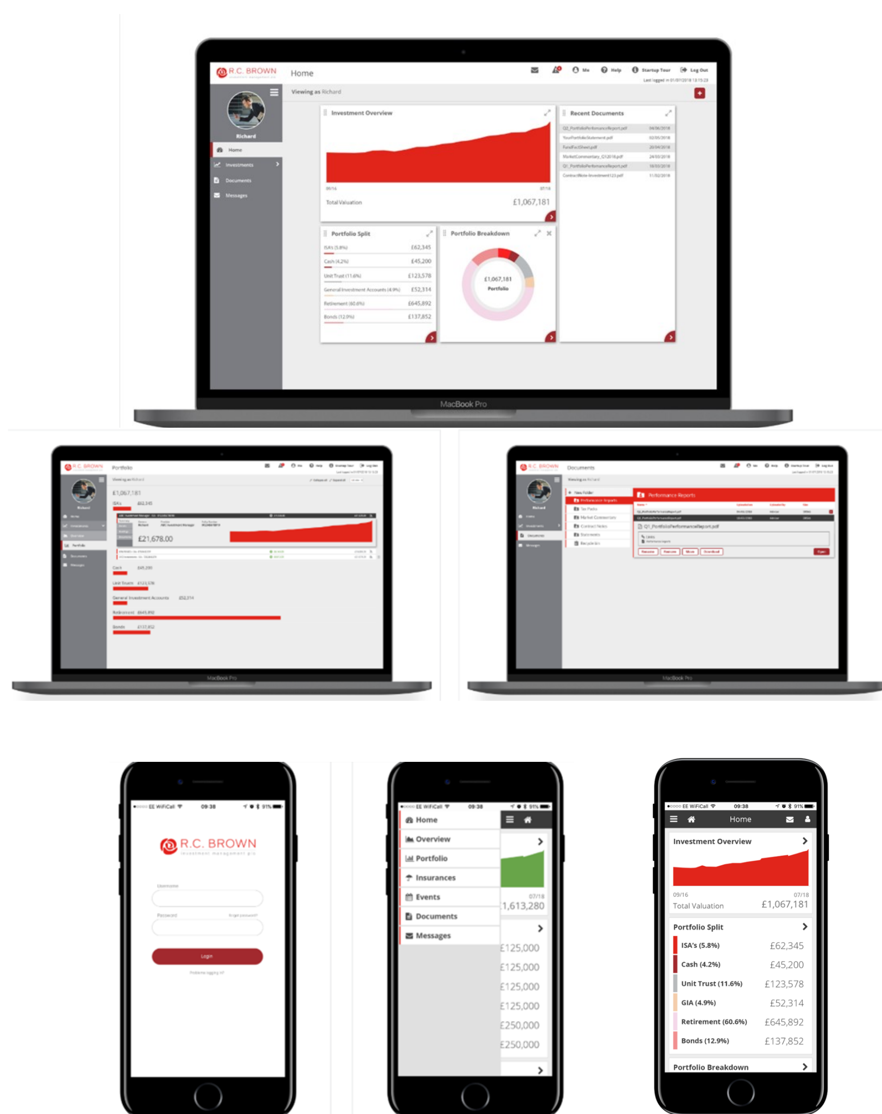
SERVICE IMPROVEMENTS

New secure portal

As mentioned in last quarter's newsletter, we are in the process of piloting a new secure portal, for both Advisers & Clients. In addition to having access to daily portfolio valuations, we are also adding the following services:

- Historic valuation charts / graphs
- Secure messaging for instructions
- Quarterly report access & storage
- Desktop / laptop & mobile App access



This will be rolled out across all existing Introducers & Clients over the coming weeks.

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