

Investing Insights

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Alongside our internal investment team, we utilise a carefully researched selection of world-class Australasian and global external investment managers, chosen for their expertise in managing a particular asset class. We use this approach for the management of client portfolios in order to gain access to expertise, diversification across investment management styles and to reduce the risk of having assets with just a few managers.

One of these external investment managers, Sydney-based Magellan Asset Management, provides clients with an exposure to global shares utilising a strategy that includes identifying and investing in companies that have what they call a “wide economic moat”. This term refers to the protection around an economic franchise that enables a company to earn returns materially in excess of the cost of capital for a sustained period of time.

This month we have republished an extract from Magellan’s recent yearly investor report by one of their Portfolio Managers, Hamish Douglas, which looks at five cognitive biases that he believes are important to understand in order to improve one’s financial decision making framework.

NZ Funds Management believes behavioural finance is an important component of investing. Saving for retirement is as much an emotional journey as a financial journey. Magellan Asset Management were recently appointed as a manager to part of the Growth Portfolios. The rationale to appoint them not only reflects their high quality research ability but also their alignment with client objectives. In their Yearly Investor Report Magellan discusses a number of biases investors have. The ability to counter these biases makes the difference between being a good manager and a great manager.

MAGELLAN - YEARLY INVESTOR REPORT¹

“I am delighted to write to you as an investor in the Magellan Global Fund (“Fund”) for the 12 months ended 30 June 2012.

As we have stated many times, we do not manage the Fund against short term performance metrics and it is inevitable the Fund will underperform markets at some point in the future. We aim (not guarantee) to produce absolute returns of a minimum of 9% per annum, after fees, through the business cycle whilst minimising the risk of a permanent capital loss. We will continue to focus on these objectives and will not chase short term performance.

We have seen volatile and difficult investment markets over the past 12 months. The major event driving short term markets has been the European sovereign debt crisis. Notwithstanding the volatility and uncertainty, the Fund remained fully invested during the past 12 months with cash at 30 June of 5.1%.

We continue to consider the risk of a systemic financial system meltdown as a result of the current European

sovereign debt crisis as low. We continue to hold this view notwithstanding dramatically higher credit default swap costs for certain European sovereign debt, soaring sovereign bond yields, an undercapitalised European banking system and credit rating downgrades for both banks and sovereigns.

Whilst we consider the risk of a financial Armageddon event to be low, the probability is not zero. As we have commented in prior investor letters, we believe that a key lesson from the global financial crisis is that prudent portfolio construction is critical for reducing risk, and particularly important in the circumstances that a “tail event” strikes. The key to prudent portfolio construction is to ensure an investment portfolio does not have a high level of aggregation risk (i.e. the risk attached to similar economic, competitive or regulatory forces) and avoiding or minimising exposure to speculative excesses or bubbles. We feel comfortable with the overall risk profile and construction of the Fund’s portfolio and believe it is likely to exhibit substantially less downside risk than the market in the event that the situation in Europe deteriorates materially.

(1) Magellan Asset Management Magellan Global Fund Yearly Investor Report - 30 June 2012.

The extraordinary policy responses in recent years, particularly by the Federal Reserve and ECB, have fuelled a number of current bubbles and distortions in certain asset markets, most notably foreign exchange and bond markets. It is inevitable that these distortions will unwind at some point and there is a reasonable chance that bond prices and foreign exchange markets could adjust very rapidly. The longer these policy responses are held in place, the more complacent investors are likely to become, believing that this environment is the “new normal”. These policy settings will not last indefinitely and we consider the portfolio is well positioned for the eventual correction.

We believe it is critical to understand common human cognitive or psychological biases that often lead to poor decisions and investment mistakes. Cognitive biases are “hard wired” and we are all liable to take shortcuts, oversimplify complex decisions and be overconfident in our decision-making ability. In a section of the June 2010 Investor Letter I outlined five key cognitive biases. In the following section I have included five additional cognitive biases that I believe are important to understand in order to improve one’s decision making framework:

1. HINDSIGHT BIAS

Hindsight bias is a tendency to see beneficial past events as predictable and bad events as not predictable. In recent years we have read many explanations for poor investment performance blaming the unpredictability and volatility of markets. In our view some of the explanations are as credible as a school child complaining to the teacher that “the dog ate my homework”. Whilst we have made mistakes we will not blame our mistakes on so called unpredictable events. In fact, not a single mistake we have made over the past five years could be attributed to an unpredictable event or market volatility but rather to errors of judgment. We have always sought to candidly outline our investment mistakes in our Investor Letters (including our investments in SLM, Lloyds Banking Group and Nutrisystem) and will continue to do so in the future. I probably should add at this point that I believe we were somewhat lucky in September 2008 when we decided to sell our major investments in financials. At that moment their share prices were near all-time record levels immediately following the collapse of Lehman Brothers. The market was materially mispricing the macroeconomic risk and we were able to act. This was in no

way predictable. We were focused on avoiding risk and in doing so, received a free kick.

In our view, hindsight bias is a dangerous state of mind as it clouds your objectivity in assessing past investment decisions and inhibits your ability to learn from past mistakes. In order to reduce hindsight bias we spend significant time upfront setting out in writing the investment case for each stock, including our estimated return. This makes it more difficult to “re-write” our investment history with the benefit of hindsight. We do this both for individual stock investments and macroeconomic calls.

2. BANDWAGON EFFECT (OR GROUPTHINK)

Bandwagon effect, or groupthink, describes gaining comfort in something because many other people do (or believe) the same. Warren Buffett tells a story about the oil prospector who dies and is in a large crowd of other oil prospectors who are all waiting at the gates of heaven. All of a sudden the crowd disperses. Saint Peter asks the oil prospector why the crowd dispersed. The oil prospector said it was simple: “I shouted oil discovered in hell.” Saint Peter asks the oil prospector why he would like to be let into heaven. After thinking for a while the oil prospector says, “I think I will go and join my colleagues as there may be some truth in that rumour after all.”

In our view, to be a successful investor, you must be able to analyse and think independently. Speculative bubbles are typically the result of groupthink and herd mentality. We find no comfort in the fact that other people are doing certain things or whether people agree with us. At the end of the day we will be right or wrong because our analysis and judgement is either right or wrong.

In avoiding the pitfalls of the bandwagon effect I am reminded of the Robert Frost poem, “The Road Not Taken”, where he writes:

“Two roads diverged in a wood and I,
I took the one less travelled by,
And that has made all the difference.”

While we don’t seek to be contrarian, we have no hesitation in taking “the road less travelled” if that is what our analysis concludes.

3. RESTRAINT BIAS

Restraint bias is the tendency to overestimate one's ability to show restraint in the face of temptation. This is most often associated with eating disorders. Most people are wired to be "greedy" and want more of a good thing or a "sure winner". For many people, money is the ultimate temptation. The issue for many investors is how to properly size an investment when they believe they have identified a "sure winner". In our opinion, many investors have come unstuck by overindulging in their "best investment ideas". Many seasoned investors loaded up on financials during 2007 and 2008 in the belief that they became more and more compelling as their share prices fell. In our opinion, "sure thing" investments are exceptionally rare and many investments are very sensitive to changes in assumptions, particularly macroeconomic assumptions.

In order to overcome our natural tendency to buy more and more of our best ideas we hardwire into our process restraints or risk controls that place maximum limitations on stocks and combinations of stocks which we consider to carry aggregation risk. The benefit of risk controls to mitigate the human greed tendency is well captured by the quote from Oscar Wilde: "I can resist everything except temptation".

4. NEGLECT OF PROBABILITY

Humans tend to completely ignore, or over or underestimate, probability in decision making. Most people are inclined to oversimplify and assume a single point estimate when making investment decisions. The reality is that the outcome an investor has in mind is their best or most probable estimate. Around this outcome is a distribution of possible outcomes, known as the distribution curve. The shape of the distribution curve of possible valuation outcomes can vary dramatically depending on the nature and competitive strength of an individual business. Businesses which are more mature, less subject to economic cycles and have particularly strong competitive positions (examples would include Coca-Cola and Nestlé) tend to have a tighter distribution of valuation outcomes than businesses that are less mature

or more subject to economic cycles or are more subject to competitive forces. Examples in our portfolio would include Wells Fargo, eBay and Google. In our portfolio construction process we distinguish between the different types of businesses to account for the different risks or probabilities of outcomes.

Another error investors make is overestimating or mispricing the risk of very low probability events. That does not mean that "black swan events" cannot happen but overcompensating for very low probability events can be costly for investors. We seek to mitigate the risk of "black swan events" by including in the portfolio a meaningful proportion of businesses (purchased at appropriate prices) where we believe the distribution curve of valuation outcomes is particularly tight. We term these businesses as high quality long cycle businesses. We believe the risk of a permanent capital loss from a "black swan event" in this part of the portfolio is low. If we have real insight that the probability of a "black swan event" is materially increasing and the pricing is attractive to reduce this risk, we will have no hesitation in making a material change to the portfolio, particularly our holdings of shorter cycle businesses. The issue for investors is assessing when the probability of such an event is materially increasing. It is usually not correlated with the amount of press or market coverage on a particular event. Warren Buffett recently said in an interview (7 May 2012, CNBC): "The worst mistake you can make in stocks is to buy or sell stocks based on current headlines".

For example, it is our view that the risk of a financial Armageddon event due to the European sovereign debt crisis has actually decreased this year primarily due to the liquidity provided to European banks by the ECB last December and again in February this year. Notwithstanding this reduction in risk the financial media has been in near hysteria about the increasing chance of the collapse of the Euro in the near term.

5. ANCHORING BIAS

Anchoring bias is the tendency to rely too heavily, or anchor on a past reference or one piece of information when making a decision. There have been many academic studies

undertaken on the power of anchoring on decision making. Studies typically get people to focus on a totally random number, like their year of birth or age, before being asked to assign a value to something. The studies show that people are influenced in their answer, or anchored, to the random number that they have focused on prior to being asked the question.

From an investment perspective, one obvious anchor is the recent share price. Many people base their investment decisions on the current share price relative to its trading history. In fact, there is an entire investment school of thought (called Technical Analysis, an amusing term in itself) that bases investing on charting share prices.

Unfortunately where a share price has been in the past presents no information as to whether a stock is cheap or expensive. We base our investment decisions on whether the share price is trading at a discount to our assessment of intrinsic value and we have no regard as to where the share price has been in the past. We also have little regard to the prevailing share price in deciding to invest the time to research a new investment opportunity.

We know share prices continually change and we want to have a range of well researched investment opportunities so that we can act on an informed basis when prices move below our assessment of intrinsic value”.

For further information on Magellan Asset Management see www.nzfunds.co.nz/ourmanagers-magellan.html

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