By Ainsley To

INVESTMENT

The bliss of ignorance

In theory, financial theory and practice are the same. In practice, they aren't. No amount of education can change that.

Is additional financial education going to create more problems than it solves? And if so, are there alternatives to simply increasing the quantity?

The very concept of financial literacy would imply there are clear definitions of the truth. The problem is that finance suffers from what Andrew Lo calls "physics envy". Because of the reflexive nature of capital markets, theories tested in a lab cannot be applied directly into practice with the confidence of other sciences (central bank forward guidance being a great example of this). Absolute truths are often only available in hindsight and any *ex ante* theory is open to subjectivity. The danger lies in the fact that, because we as humans are averse to ambiguity, we seek further comfort in our theories by assuming away uncertainty in our models – to the point that we are sacrificing practical usefulness in exchange for trying to explain the unexplainable.

> "The only true wisdom is in knowing you know nothing." – Socrates

We can see the dichotomy of theory and practice in what the real experts say versus what they actually do. Harry Markowitz's modern portfolio theory has been widely taught for decades as a framework for making investment decisions, but Markowitz himself doesn't use Mean Variance Optimisation (see Jason Zweig's *Your Money and your Brain*). Since one of the key assumptions that you can predict future returns and volatilities does not hold in reality, he used equal weighting for his personal asset allocation.

Ray Dalio, businessman and founder of investment firm Bridgewater Associates, may have spent 40 years developing his model of "How The Economic Machine Works" but to this day his and his family's wealth are all in risk parity strategies since he is not confident of his ability to predict the future in practice.

Similarly, Warren Buffett, who has turned value investing and stock selection into a modern-day religion, has all his wife's assets in a tracker fund and suggested many investors today do the same. Simplicity and humility are rarely the refuge of the theoretically uninformed, but often the result of tried and tested practical experience.

Unfortunately the road to financial wisdom is non-linear. Beyond the basic level of knowledge, financial education goes through a period of negative carry due to the costs of incremental hubris (see graph). Overconfidence and the Dunning-Kruger effect have been well documented for all types of investors. More exposure to financial theory could have the unintended consequence of leading more investors down the slope of incremental hubris.

So if the actual experts don't know, and many self-proclaimed experts don't know that they don't know, what chance do individuals have of being educated to a level where they know? Perhaps a more pragmatic approach than expecting every individual investor to achieve financial enlightenment is to focus on other areas.

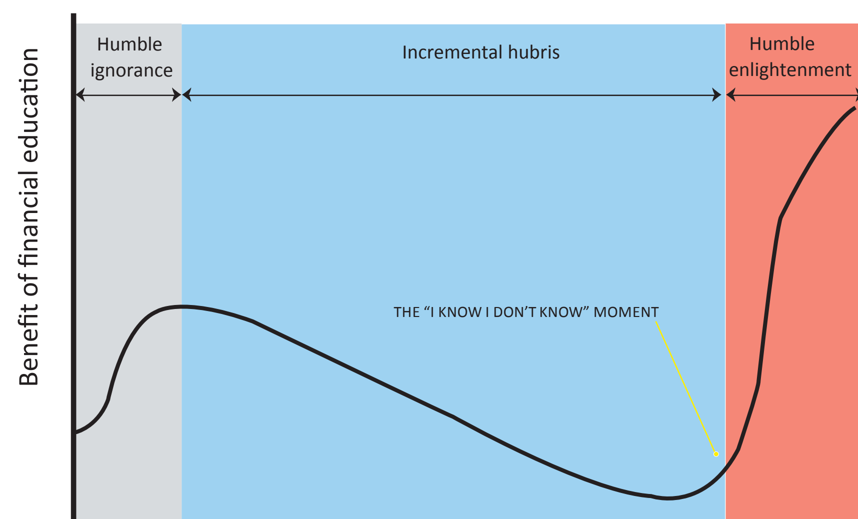
Avoiding miseducation

One of the main forces pushing individuals onto the path of hubristic 'macro tourism' is the financial media. Jason Zweig summed up the conflicts in today's financial press very well: "There are three ways to get paid for your words: 1.) Lie to people who want to be lied to and you'll get rich 2.) Tell the truth to those who want the truth, and you'll make a living 3.) Tell the truth to those who want to be lied to, and you'll go broke."

With or without more financial education, it can be extremely difficult for many retail investors to validate an 'expert' opinion.

Yet many actually end up making financial decisions based purely on the untailored, unregulated and unaccountable 'advice' they hear through mainstream media outlets. The vicious circle of newsflow-prompted turnover, leading to price volatility and ultimately back to more fear-induced news watching is a tax on all investors.

THE INVESTOR'S LEARNING CURVE



SOURCE: Credo

Perhaps more stringent regulation in the form of wealth warnings ("FOR YOUR ENTERTAINMENT ONLY, DON'T TRY THIS AT HOME!") and higher standards of accountability for pundits can help give investors a less biased perception of expertise (e.g. "999 999 out of 1 000 000 lottery tickets did not win").

Between the extremes of complete freedom of speech and blanket censorship there should be a happy medium where financial pundits and retail investors share the spoils. Unfortunately more wealth is being destroyed today from brainwashed investors attempting to be Warren Buffett than the Oracle of Omaha has made over his whole career.

Breaking the behavioural barriers between knowledge and action

Another wedge between theory and practice are the behavioural barriers that obstruct financial knowledge from resulting in action. According to data from the UK Pensions Regulator, the success of auto-enrolment in that country is testament to how we can use behavioural insights to improve decision-making for savers without the need for financial education. An investor's savings rate is one of the few things in their control and simultaneously the biggest factor affecting the size of their retirement pot – utilising inertia through automated contributions can turn this bias from a headwind to a tailwind for savings. Similarly, defaulting to systematic rebalancing can help mitigate the disposition effect and irrational loss aversion.

Direct incentives such as fees can also improve investor outcomes more effectively than knowledge. Loyalty discounts can incentivise an investor to increase their time horizon – if clients feel they are getting a better deal through longer-term investing, this could help reduce overtrading and short-term performance-chasing that continue to be so pervasive.

Despite any level of financial literacy, many investors (both fiduciaries and asset owners) are unable to completely avoid the temptation to speculate. Structuring an investment solution so that a small portion of the portfolio is dedicated to "speculation" from the outset can satiate an investor's lust for action. Though the expected return from these trades is negative, the benefits could outweigh the costs if it can divert one from taking out one's emotions on the entirety of one's portfolio.

Conclusion

A minimum level of initial financial education remains invaluable for any individual. But the worst enemy of most investors over the long term is not the market, it is they themselves. Teaching investors to make the theoretically optimal financial decision brings no guarantee that they can implement and stick to those decisions in practice. Humanity's reach already exceeds its grasp, let's focus on improving the latter. ■

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