

Chance is a fine thing – but not in the world of investing

Have you ever been humming a song just before it is played on the radio; or been in a rush when every traffic light turns red just as you approach; or thought about a friend you haven't spoken to in years who suddenly calls? Seemingly impossible coincidences, right?

A series of fortuitous events might make you feel lucky. Less fortunate ones could make you feel jinxed.

However, according to John Littlewood, a renowned Cambridge University mathematician, this is purely a case of misjudging the role of chance in our lives.

He has calculated that we experience about 1m "events" per month. Most are so mundane or expected that they pass unnoticed. However, every now and then we experience some strange coincidences which we view as having real significance.

For what it's worth, a lucky streak doesn't jinx you and, unfortunately, a string of bad runs does not mean better times are in store. Yet this fallacy affects more people than you might think, if not at a conscious level, then on an unconscious one. Ask anyone who plays roulette whether they would be more inclined to bet on red after a string of black results. For those who expect good luck to follow bad and vice versa, the gambler's fallacy can be a tricky illusion to shake.

In the above form it is pretty innocuous. But in other aspects of our lives it leads to decisions that are not in our best interests

GARY CONNOLLY COMMENT



— no more so than in the realm of investing.

In flipping a coin four times, which of the following two patterns do you think is more likely? HHHH or HTHT, where H is heads and T is tails?

There is only a 1 in 16 chance of flipping four heads in a row, so the more random appearing pattern is surely more likely?

In fact both are equally likely, even if this seems counterintuitive.

Most people find long series of consecutive results much less likely than they really are. A string of four heads starts looking like a pattern when, in fact, there isn't one.

A string of eight or nine will have a crowd looking for any cause other than random chance. In reality, there is a good chance that at least one of these long runs of consecutive results will occur if you flip a coin for long enough.

It's human nature to look for patterns and assign some significance to them. There are many shortcuts we take or use in assessing patterns and making decisions. These shortcuts can play an important role in decision-making and sometimes lead to systematic errors.

The old stock market adage "sell in May and go away" recommends that you take the summer off and give your portfolio of stocks a rest.

Much has been written about this apparent anomaly and it's tempting to believe that we can juice the returns from our portfolio from doing essentially nothing other than selling stocks in May and moving to cash until September after the St Ledger horse race, the last classic of the season.

So consistent has this pattern been that there is a myriad of papers attempting to "explain" it. The tendency to find patterns in data has some unfortunate consequences for our investment behaviour. It leads us to attempt to time the market and, worse, causes us to be a lot more active with our portfolio than we should.

Over shorter periods, the market can appear irrational and unpredictable — a bit like flipping a coin. Those who attempt to time the market could, by chance alone, be proven right on a good few occasions, thereby reinforcing their false sense of optimism about the effectiveness of their strategy. But in the long

term, market timing is more like playing with a roulette wheel where the market is the casino with a slight winning advantage.

There is lots of evidence to suggest that, when comparing results of investors, the less active ones — those with lower turnover — have significantly better net returns than their more active counterparts. In other words, less really is more when it comes to investing.

There is a winning strategy but it becomes evident only over a long period. To take advantage of the market's long-term winning advantage, it is essential to avoid emotions and be patient. Investors should construct a widely diversified portfolio and trade infrequently, taking the opportunity to rebalance periodically by selling winners and recycling the funds to the out-of-favour assets.

If you are particularly disciplined or well advised, and can endure periods of underperformance, adding a size and value bias to your fund selection should add more juice to your ultimate return.

Chances are most will ignore this advice, or if they follow it, will do so only up to a point.

The only reason above-average returns are available from a strategy such as this is because it is unlikely the majority will stick to it. For the patient and disciplined, long may this remain so.

Gary Connolly is managing director of iCubed, an investment training, research and consulting company, and chairman of valueinstitute.org; gary@icubed.ie