Hyperopic Investor in a Myopic World!

“The single greatest edge an investor can have is a long-term orientation.”

- Seth Klarman

Dopamine, also known as a ‘pleasure chemical’, is produced in the brain and gives us a natural high (a euphoria) when we get what we want. It responds to getting good food (when you are hungry), chocolate, alcohol, sex, recreational (illegal) drugs and … Profitable financial investments. The feeling of making money is hence akin to experiencing a high with pleasure-inducing drugs! There are two other characteristics of Dopamine: a) Dopamine also responds to an anticipation of monetary rewards and nudges us to act b) If the reward doesn’t increase after some time, Dopamine is not generated in the neurons. For investors, this has major implications. Firstly, we are induced to trade more whenever we think we have an opportunity (for instance, if we keep watching the ticker too much). Plus, when we crave a high, we are tempted to keep increasing the stakes or bet on ‘fast moving’ (hot) stocks. Neuroeconomics is hence telling us that we are naturally inclined towards short term view of investments. It takes a lot of discipline to resist these emotions and focus on long term.

In the past few months, the focus on short term has increased substantially. The pandemic has got us chasing near term data points. The equity markets have risen very sharply, and a lot of new retail investors have entered the markets. We had already discussed in one of our previous issues (What could possibly trouble a tiger here), how the young and inexperienced investors typically trade more frequently, follow trends (herding), chase hot stocks and end up taking higher risk. The unprecedented sharp upmove has left a lot of experienced
investors with the feeling of missing out and a lot of them are yearning to participate. **Trading apps** don’t force investors to trade but they definitely persuade them by constantly sending price alerts and notifications. There is **pressure on institutional investors** too, as financial media and social networks are discussing how funds performed in the last 4-5 months instead of their long-term track record. The rise of passive funds, algo traders and high frequency traders have tipped the scale further towards investors who are focused on short term momentum. And of course, the **leveraged investors** are anyways forced to react to short term news flows rather than long term company fundamentals.

Now, more than ever, investors need to have a long term view.

**TAKING A LONG-TERM VIEW**

As it is clear from the arguments above, there is very less competition if you are looking to invest with a long-term horizon. Since a majority of investors are trying to outsmart each other in the near term, joining this herd is likely to generate only average results. The opportunity for superior returns is in looking beyond three years (5-10 years is better) and investing in businesses or investment themes which are not fully appreciated by this crowd. Once you change the investment horizon, the entire view on market movements, asset allocation, fund manager selection and stock selection changes. The benefits are huge:

- **Love the downturns:**
  With a longer investment horizon, you are prepared for a crisis. Even good businesses will run into downturns. But with a longer-term view, one is ready to participate by adding onto the positions during the falls. A lot of short-term investors miss out on a good business by trying to frequently trade in and out of the stock. Even a second wave in Covid pandemic and the resultant downturn can be used intelligently by an investor who is investing for a decade.

- **Take advantage of crowd biases:**
  Typically crowd which is dominated by short term investors and inexperienced investors is guided by biases like greed, fear, myopic
Loss aversion, recency bias, overreaction or underreaction to new information etc. Broaden your horizons and use the crowd errors to your advantage. This is often referred to as Time Arbitrage as it involves making an investment in an asset with good long-term prospects at a time when it is undergoing short-term issues.

➢ Enjoy a broader opportunity set:
Herding leads to market participants being focused on certain hot stocks or glamour stocks and ignoring a lot of other companies which may have good businesses but are under the radar. Short term investors concentrate on stocks that grab their attention either due to their sharp movement or media coverage. A long-term investor is looking for good businesses at a good price. Since noise or liquidity are not much of a consideration, one is able to have a larger number of companies to choose from.

➢ Capture important themes and styles:
Certain macroeconomic themes (like return of global inflation), demographic themes (women increasing participation in workforce), geopolitical themes (Atmanirbhar Bharat) unfold over many years. Only long-term investors can fully utilize the wealth creation opportunity in Industries and companies that benefit from these themes. Also, investment styles like value investing require patience and long-term horizon which these investors can utilize.

➢ Filter out the noise:
A market participant is bombarded with a lot of information, whether material or not. And it is difficult to differentiate between signal and noise. Using the filter of a long-term orientation, a lot of data points which are of low significance can be removed.

➢ Bond with your friends who believe in market efficiency:
You obviously want the value of bargains that you discovered (by the actions of short-term investors) to be realized over the long term. As Benjamin Graham said, “In the short run, the market is a voting machine but in the long run, it is a weighing machine”. Join your friends who believe in market efficiency and secretly hope this time the crowd overreacts on the upside 😊
➢ Other benefits: A long term investor:
   o Does not view a Cash balance in the portfolio as opportunity cost, but as ‘opportunity preparedness’
   o Takes advantage of the volatility and absurd quotes that Mr. Market brings
   o Focusses on distance between stock price and intrinsic value rather than 52 week high or low, or volume breakouts

THE RIGHT SUPPORT

Just having a long-term view on the investments cannot guarantee success. There are some problems the investor will encounter. I have listed some important ones with a suggestion to handle each one:

➢ Future is difficult to forecast accurately. It is also difficult to find third-party long-term forecasts as most of the analyst make only near-term projections (within a period of 1.5 years)
   o A diversified portfolio bought with a margin of safety can cushion the investor from possible errors in forecasting. How to improve forecast can be found [here](Exact Estimate)

➢ There is a career/business risk if the client or the organization is not supportive of the strategy
   o Set up the right ecosystem with clear communication of strategy and expected outcomes. Incentive structures can also be set based on long term results.

➢ Time is a friend of a wonderful investment but the enemy of a bad one
   o The investment horizon has to be backed with a good investment process of evaluating and selecting investments

The right support structures (clients, organization, team, investment process) will help an investor on the path of long-term wealth creation. However, on a personal level, the investor will have to maintain the discipline. It is tempting to join the crowd and easier to focus on the next quarter than next decade. It will however be far more lucrative to resist the temptation and turn your investment horizon into your investment edge.
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ABOUT STOIC INVESTOR:
The word “Stoic” is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the “Stoic investor” as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).

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