

WESCAP MANAGEMENT GROUP

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Events and Items of Interest to WESCAP Clients and Other Interested Readers

INVESTMENTS

Risky Business

There is no such thing as a riskless investment or portfolio. Every investment or strategy has risk trade-offs. Despite their many uses, many traditional measures of risk (e.g., standard deviation, beta) do not take into account how we, as human beings, tend to process information and make decisions.

Consider the following two exercises, which may also give you some insights into your own risk tolerance "function".

Exercise 1--Select either A or B and then select C or D (two decisions to make):

Decision I

- A. Collect a sure gain of \$240
- B. Take a 25% chance to gain \$1,000

Decision II

- C. Take a sure loss of \$750
- D. Take a 75% chance to lose \$1,000

Exercise 2--Consider this personality sketch: Linda is 31 years old, single, outspoken and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice and also

participated in anti-nuclear demonstrations.

Which event is more probable:

- Linda is a bank teller.
- Linda is a bank teller and is active in the feminist movement.

In the first exercise¹, 84% of participants chose A over B and 87% chose D over C. Overall, 73% selected A and D together and only 3% selected both B and C. However, on average the choice of B and C together results in an expected payout \$10 better than A and D. Traditional expected return theory would not result in anyone picking what indeed most people did pick--A & D. Which did you pick?

This first example shows that most investors are willing to pay a premium to have a sure gain. Also, they seek to avoid a sure loss. This type of risk aversion is quite common. While this may lead to less-than-optimal investment returns, it is rational from the perspective of the risk function used by the investor.

As to our second example², the more probable occurrence is that Linda is "a bank teller" only. The second choice has a lower probability since it requires her to be *both* a bank teller *and* something else (a smaller subset of being a bank teller

only). Yet, 87% made the second choice. Which did you choose?

This second exercise is a good example of the power of association, which allows us to make decisions in situations for which we do not have prior experience, but which are similar to other experiences or learned knowledge. However, this decision process can often lead to systematic bias, leading to errors.

For example, when a market or investment has a bad return year, most investors are reluctant to buy, even though it represents a more attractive buy than previously (all else held constant). "Bad" past performance becomes **associated** with likely "bad" future performance, even when there is no factual reason for the association (i.e., no serial correlation). A similar association bias exists when something has done well in the recent past. Are you more or less likely to invest in the U.S. stock market after it has already done well, such as in 1995?

For many, risk tolerance is not fixed, but variable--becoming more risk averse after losses and more risk tolerant after

gains. This behavior, on average, results in poorer long term performance. A number of behavioral and empirical investment return studies support this.

Understanding how you perceive risk and react to gains and losses can help you create a portfolio strategy which both conforms to your risk-taking tendencies and to sound investment theory. If you can identify systematic biases in your decision-making, you can also add methodologies and portfolio restraints that limit or even reverse this bias.

Due to difficulties in self-identifying these biases, in many cases it may take outside assistance to identify your various and perhaps contradictory risk avoidance tendencies (the prior two exercises are a beginning). You then are ready to develop a rational portfolio strategy that takes these into account.

New Ways to Contact WESCAP

As we mentioned previously, we check our E-mail at least once per day (WESCAP@aol.com). You can also use our fax number (818) 552-2133. We have recently added a toll free number for your convenience: (800) 820-2453.

¹ Amos Tversky, "The Psychology of Decision Making", ICFA Behavioral Finance and Decision Theory in Investment Management, 1995, Association of Investment Management and Research (AIMR).

² Daniel Kahneman and Amos Tversky. 1982 "The Psychology of Preferences." Scientific American (January-June):167-73.

If you have questions about the above, please contact Mark Gleason, Rick Weinlein or Joel Edstrom. WESCAP Management Group has obtained information from sources believed to be reliable, but no guarantee can be made as to its accuracy. WESCAP Management Group provides high quality, personalized, objective financial and investment advice to individuals.