

Tia's Bets

Some Ideas about where to Concentrate Research Efforts

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The *Financial Times* recently reported on a project conducted by a British psychologist from the University of Hertfordshire. This project involved a stock market contest in which the participants were a respected professional market analyst, a full-time market astrologer and a five-year-old girl, Tia Roberts. As the BBC reported, the three participants each invested £5,000 in a stock portfolio of their choosing. After a year, with performance of +5.8%, Tia's portfolio had left the two professionals way behind and at the same time comfortably beaten the market, the FTSE-100 having lost around 16%.

Sounds familiar, I hear you say. For years we have been coming across these fairly daft looking contests, and time and again it has been the monkey testing his stock picking skills by throwing darts at the share prices in a newspaper that has outperformed the analysts with a certain regularity.

You can say what you like about these things. But the fact is that such exercises have a habit of generally discrediting the analysts' profession, financial market research and also investment advice. This is a far from trivial matter, precisely because trust and credibility are vital factors in the general public's perception of this profession.

Why are there these little games? What is the problem?

My view is that one of our main problems is poor communication. It may also be the case that individual groups within our profession are not entirely honest or quite simply overestimate themselves.

The academic literature is full of works that state that the markets are fairly efficient. And I say deliberately and explicitly *fairly*, since there can never be a digital answer to the question of efficiency of information. And *fairly efficient* quite simply means that the most relevant information is immediately reflected or digested in the prices on the financial markets. Is the empirical evidence on the matter of market efficiency conclusive? Not completely. But it is sufficiently certain to be able to say with good reason that for day-to-day work on the markets, the efficiency hypothesis can and must be assumed to be completely safe for all private investors and also for the overwhelming majority of institutional investors.

Is that a problem for our profession? Maybe. But if we are honest, most probably not. Since we are well aware of how market efficiency arises: we produce it ourselves. It arises because a large number of analysts and market players are permanently on the lookout for as yet undigested information and as soon as they think they've found something, they act appropriately and ensure that the very latest piece of information is immediately reflected in the prices. Because each piece of price-relevant information can necessarily pop up only randomly, in expected value terms prices must also in the short term move randomly.

If only we were all of us prepared to accept this fact and to communicate more, there would be much less misunderstanding regarding what analysts and investment advisers can do.

We would then no longer be put repeatedly in the same box as meteorologists, whose forecasting skills have in fact improved markedly over the past few years.

It is not simply the incompetence of analyses or the inability of analysts that result in Tia's bets happening to do better than the professionals' tips. Quite the contrary. It is precisely the rapid interpretation of 'news' and in turn the rapid reflection of each new item of information in the prices that makes a systematic forecast impossible. Or to put it another way: it is precisely the sum of the attempts to make the impossible possible that ends up making what might be possible impossible.

And this is very different from the case of meteorologists. In the social sciences the prices are endogenous to the formation of expectations and dependent on new information, whereas in meteorology the determination of weather is exogenous to analysis.

Does this mean that we do not need any analysts because they have nothing to contribute to the forecasting process and that the banks and securities houses have all been investing wrongly for years? This question has been discussed for some 20 years and has entered the literature as the Grossman/Stiglitz paradox (Grossman/Stiglitz, *American Economic Review*, 1980). But it is only the fact that many analysts day by day digest the relevant information that results in the prices being information-efficient. If the analysts were sacked, the prices would no longer be information-efficient and it would be worth getting the analysts back again.

But we are certainly not in this situation today. Quite the contrary. If anything, we probably invest too few resources in short-term analysis (or to put it another way, in commission-hungry and commission-driven brokerage research) in which we lose in the event of doubt to Tia's bets because we can hardly beat them in expected value terms. If, however, we invest substantial resources in short-term analysis – and proudly announce the fact as well – then we must also not be surprised to find that it is generally assumed that analyst-based bets should prove much better than Tia's bets.

This means that we should ask ourselves whether we should not perhaps increasingly focus our resources on where we know that we really can achieve added value with our analyses. And in this regard I am thinking not only of staffing resources at banks but also of research resources at universities and research institutes.

Areas that come particularly to mind in this respect are asset allocation or investment strategy, equilibrium concepts, valuations, risk management, financial engineering, etc. I'm also thinking of areas from which financial market research in both Switzerland and Germany has almost completely withdrawn: areas such as corporate control, corporate governance, financial accounting, financial and banking regulation, and suchlike. In our research efforts, we have heavily neglected these areas over the past few years. While these questions largely cover matters that fundamentally deal with financial theory and are often very complex, it is in fact the case that many of the advances and mistakes made in these areas over the past few years suggest that theoretical financial market research has not taken enough account of the corresponding questions, even though the corresponding expertise would have been in demand.

I'd just like to cite a few examples. Even only a few years ago, financial accounting served solely to give a reasonably intelligible overview of how a company's transactions proceeded in an accounting period and how the asset situation looked on a given reporting date. It was the means to an end. And sometimes you couldn't help thinking that a given end justified all possible means.

Now things look completely different. With the increased focus on shareholder value, with the growing realisation among shareholders that the company actually belongs to them, certain conflicts of interest have become apparent that were dealt with in the context of both the principal/agent discussion and in theory. Such questions could not fail to have an impact on the entire financial accounting and financial control discussion. This led, on the one hand, to an increase in transparency in accounting and, on the other, to the implementation to some extent of homogeneous standards. A company's presentations of its financial transactions and its balance sheet situation were now put on a completely new footing and should wherever possible be reported in accordance with the true and fair principle. The development of appropriate standards led to the emergence of what is now FER in Switzerland, USGAAP in the USA and the International Accounting Standards, IAS. Suddenly, exorbitant resources were allocated to achieving the appropriate objectives and implementing the appropriate regulations. In doing so, you often have the impression that accountancy is some kind of exact science that is an end in itself. That this occasionally involves taking decisions or drawing up rules that do not exactly give great insight into a company's management has a lot to do with the fact that many people – and here I'm thinking not least of some of the more competent analysts and academics – will not get involved in such bodies in the first place because it is of course impossible to earn any real plaudits there. It is of course perhaps more interesting for a young academic to delve deeper into the Black/Scholes equation than to investigate management options regarding valuation and accounting matters. But today it is precisely these areas that are of vital importance if companies are to be run in accordance with rational scientific and financial criteria.

This might all sound rather academic. But, as an example, we are now in a situation where the accounting regulations for an insurance company quite simply make it impossible to run the company in accordance with economically rational principles. Quite simply, because of the accounting regulations, it is now no longer possible in many areas to take steps to optimise the economic value. For example, it is a fact that the necessarily long investment horizon of pension funds cannot in many places be observed, because the compulsion to use the lower-of-cost-or-market principle or some other principle and the increasing infeasibility of showing loss equalisation reserves in the balance sheet either at the year-end or quarter-end no longer leave any leeway to undertake long-term rational asset allocation.

The way in which business reporting is at times tackled by audit companies nowadays – Enron comes to mind – is more like an inquisition than an attempt to give the shareholders and other stakeholders a true and fair view of the transactions and the asset situation and to give companies an opportunity to increase their value in a rational manner.

Why do I say this here? I say this here because it is precisely in the area of financial market research that there are developments that could have far-reaching significance for further developments in the area of accounting standards and control. And I would like to call upon people to involve themselves more in the appropriate boards and workshops in order to systematically bring about further developments in investment and corporate finance research.

It is no use our showing management incredibly sophisticated models with which measures of the economic value of a given business model – of a given company – can be maximised, if the accounting standards are not then capable of adequately replicating the corresponding events. Input is required here and the bodies responsible for a rational accounting policy need it too. And if people are not prepared to provide this input, then there is no point in cursing the incompetence of the auditors or the accounting policy boards in retrospect.

I have experience of many examples from the world of investment management that provide food for thought. And right now we are experiencing dramatic intensifications of the accounting rules in many and varied ways. And it must be clearly understood that it is not my

aim to criticise this intensification, since what is involved is nothing more than an attempt to create greater transparency, which is in itself entirely laudable. It is only that there are far too few people in the appropriate bodies that have sufficient overview to understand the business models in addition to the accounting rules or rather the economics of the respective business models. Another small example – only by way of illustration – would be the rules on the individual valuation of stocks in an indexed equity portfolio. If any stock in such a portfolio is below cost, then depending on the accounting standard we have before us, it must be written down in the profit and loss account. The fact that all the other stocks in the indexed portfolio are at the same time well above cost is of no interest to the accountant. Nor is the fact that this rule acts as an incentive to automatically sell each stock when it reaches its acquisition cost, increasing the tracking error, that is to say the corresponding risk. If people did not know better, this would make perfect sense. And if we did not concern ourselves with such matters beforehand and ensured the accounting policy meant what we understood it to mean, we need not be frustrated about it afterwards either.

Cooperation in such accounting policy groups would in many cases probably achieve more than the umpteenth study on Nestlé or an attempt to justify why the DAX should breach the XYZ resistance line tomorrow.

In the areas of investment strategy and asset allocation, we also have comparative advantages that are still far from being exhausted.

In forming the company for financial market research, we had at the time set ourselves the objective of giving a broad audience – for many of us our clients – an understanding of academic findings in the area of strategy. This has succeeded in a number of areas. I cite the area of mutual funds. Here I am of the view (but I accept that this may simply be an illusion) that many investment clients have chosen mutual funds as a means of capital allocation not least because they have somehow understood that unsystematic risks are not discharged in the markets. I also believe that the popularity of asset allocation funds is due to the fact that many investors have understood (naturally they don't quite put it like this) that with such products they are usually building a risk/reward-optimised portfolio at least near the efficiency frontier.

However, as regards further developments in this area, we have made little progress over the past few years. In theoretical areas, there has indeed been some progress, but in the area of communications, of making things intelligible for the investment client. Today we hardly have approaches with which a client can systematically ascertain the temporal dynamics of his liabilities and at the same time optimise the structure of his investments in such a way that a certain result can be anticipated in the future while being aware of the probability of shortfall. In the vast majority of cases, we have not succeeded in making it clear to the investor that every investment problem must be seen in an asset/liability context. It is still the investment client's perception that the investment adviser or analyst should just tell him whether to go for Roche or Novartis and what their respective upside targets are.

Now I do not just want to be critical, but instead I would like to praise a number of advances that have as a result of theoretical work found expression in the practical worlds of investment and finance.

Here mention should be made of work in the area of risk management that has also been taken up by the banking regulators in order, particularly in capital support, to define more rational standards than before. And work in the area of option pricing that has found extremely wide applications, not least in product development in the investment area.

It is precisely in product development that we have made many advances over the past few years, and innumerable approaches have emerged in the product area, not least as regards strategy orientation. But, as I mentioned earlier, we are not particularly skilled in communication and training. I do not know how many products are generally doing the rounds in the market today. Just about every day I see a few new advertisements for some 'even more innovative structures'. Undoubtedly some of these products are extremely innovative and can also meet a genuine need from specific clients. In the present phase, for example, there is no doubt that products with a capital guarantee and a specific upside potential are likely to encounter very great demand. Somewhat older students might like to recall the winter of 1991 after the Iraq crash. The situation was identical to that today. Everyone was afraid of another stock market collapse and everyone wanted capital guarantee products. In such a situation we can now offer such structures with the widest flexibility and meet all possible needs.

But looking around a little in the product development labs of banks and securities houses, you can't at times help thinking that their primary interest is not so much in meeting needs as quite simply generating commission. Here as well, advice is at times too brief and investors often find themselves lumbered with things in their portfolio which mean nothing to them. It would be going too far to name individual products here. I would once again like to restrict myself to pointing out that fairness and credibility are the most important assets in our business.

Once again I'd like to take up the point that we have still not yet succeeded in making it clear to investment clients that each and every investment problem is in fact an asset/liability problem. In the case of institutional investors and pension funds, we have in this respect made very great advances and there are now hardly any pension funds that would now venture to propose an investment strategy without explicitly considering the liabilities side of the balance sheet, that is to say the obligations to pay out. We should also achieve the same thing with private investors. A private client has liability structures and has to cover future cash flow requirements in exactly the same way as a pension fund.

We must take up and cover such issues systematically in investment advice.

The first steps have undoubtedly already been taken in this regard. One example is an application that even runs on website of the NZZ, a Zurich-based newspaper and was initiated by Martin Jansen. But the crucial point is not of course that there is the odd drop in the ocean. The crucial point is that we should become aware that in these strategy-oriented areas and in such strategy-oriented research we can create added value that far exceeds what we do when we challenge Tia's bets, not just for our clients but also of course for ourselves.

Maybe I've been rather critical over the last few pages. I realise that most people attending this conference are not chiefly preoccupied with short-term wagers but are instead working on serious research projects. In this respect I wish them luck in their choice of research projects and hope that they are busy with issues that really can lead to the generation of added value. Perhaps they are even examining one of the areas I identified earlier as an issue where financial market know-how is lacking but needed.