Colin McLean – Fundamentals

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Private investors are looking on in bewilderment at the Madoff US investment scandal, grateful that hedge funds are restricted to professional investors. Ordinary investors were denied the opportunity to earn 15% or more per year, with even a month of losses an incredibly rare event. Yet this and recent stockmarket problems, offer lessons for all investors in managing portfolios – even for professionals. Volatile stockmarkets can make it easy to lose sight of basic principles. Indeed, the rules of good practice are even more important in current turbulent conditions.

In the pantomime season, anyone watching the Wizard of Oz would have recognised the concept of a magician whose skills are hidden from view, someone who would not meet investors. The dangers might seem obvious. Yet what is truly remarkable is how many investors appear to have sunk huge proportions of their personal wealth into a single investment. Even the 10% of portfolios allocated by some professional managers looks too high. This comes just weeks after many professional hedge fund investors lost huge sums betting against Volkswagen. Some let this investment run up to as much as one-quarter of their portfolios, so convinced were they by their own judgement.

Psychological studies have shown that individuals as investors have the same failings of overconfidence that is evident in other areas, such as driving. It is not just that it is human nature to make mistakes – we tend not to be good at actually assessing the chances of being wrong, or where the risks lie. This weakness is hard to cure, but the key to good portfolio management is maintaining similarly sized investment positions. One or two disproportionately large investments greatly magnify risks and might actually reflect excessive, but misplaced, confidence.

Research has also shown that investors tend to become attached to shares they already own. It can be hard to view prospects dispassionately, when so much emotion has already been sunk into buying and holding a share. Even though some shares exasperate us, we want to keep them long enough to see them rehabilitated and recover losses. As a result, most investors hold onto bad shares too long, being unwilling to sell at a loss, and desperately hoping that market values will recover to save embarrassment. Studies have shown that it is shares showing losses against purchase cost that actually can have greatest risks. Investors should bear this in mind when reviewing portfolios at the year end.

The Madoff affair also highlights the false reassurance that can be offered by being “in good company”. Investors often let their guard down when they try to piggy-back on others’ research. Too late, some now realise the danger of relying on supposed endorsements from famous names. This does apply more widely. Many now regret following the various investment gurus who called the end of the bear market at much higher index levels. It highlights the importance for investors of either doing their own research, or at least actually checking the results and judgement of anyone they rely on.

For those not personally exposed to hedge funds, Mr Madoff may have delivered some wider lessons. Investors should re-examine their portfolios, and try to look dispassionately at each investment – particularly those that have lost money this year.