Dimensional

OUTSIDE THE FLAGS

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Embracing Imperfection

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New Year's resolutions often involve making promises to ourselves we can never keep. But instead of tilting at windmills, we can often generate better results by merely resolving to be less dumb in certain areas. And money is a good place to start.

One human tendency is to judge the effectiveness of our retirement savings strategies by looking at performances on one-, two-, or three-year horizons. We do this because we are wired to be more sensitive to short-term losses than to long-term gains.

This is why much of the financial services industry and media encourage a short-term focus for an audience with a long-term horizon. This is akin to looking through the wrong end of a telescope. The thing you should be focusing on looks even farther away.

The result of this short-term mindset is that investors end up following the herd and seeking safety when opportunities are plentiful and seeking risk when opportunities are few. The less dumb thing is to maintain a level of discipline amid the noise.

Another human tendency—and one allied to our built-in loss aversion—is to be suckers for the supposedly "free" or discounted offer. Like Homer Simpson, a zero price tag makes us fall for pitches selling us stuff that is neither necessary nor good for us.

In the world of investment, it's this tendency that makes people gravitate to strategies that headline high returns without mentioning the risk, or that conveniently bury fees, commissions, and other costs. Regret lies on the other side of those decisions.

A less dumb thing is to focus on return *and* risk. They're related. Focusing exclusively on return can lead to rude awakenings when risk shows up. Focusing exclusively on risk can lead to disappointment when returns are delivered.

A third tendency among humans is to succumb to what behavioural scientists call "hindsight bias." Essentially, this is our habit of viewing events as more predictable than they really were. Call it the "I saw it coming" syndrome.

There is a fair bit of this around at the moment, with plenty of "experts" saying the sovereign risk crisis was completely predictable. This is strange, because as we saw in my previous column "Things Change," the overwhelming consensus among institutional investors a year ago was that fixed income would underperform in 2011. The crisis may have been predictable, but the market reaction wasn't.

The consequence of hindsight bias for investors is they tend to be forever rewriting history and forever seeking to interpret performance based on what they know *now* rather than what they knew a year or more before.

A less dumb thing is to accept there will always be a level of uncertainty. The future is unknowable. And all we can do as investors is to ensure the risks we take are related to an expected return, that we diversify around those risks as much as possible, and that we exercise a level of discipline amid the noise.

It's a way of embracing your imperfection, and it's a New Year's resolution you have a chance of sticking to.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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