Making Fear and Greed Pay in Investing

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Berkshire Hathaway chairman Warren Buffett's investment philosophy is commendably uncomplicated: "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

It isn't a glib quote. Buffett has walked the talk in his investment decisions, announcing a range of acquisitions, bond issuances and financial sector investments in the midst of the greatest global financial crisis since World War II.

Net earnings last year of more than US$8 billion ($10.6 billion) surely justify his strategy.

It's also fair to say there must have been a fair amount of fear exercising Buffett's mind in the years leading up to the meltdown of 2008. In fact, he was one of only a handful of business leaders who voiced concern about the sustainability of financial market growth.

Fear and greed, together with the desire to follow the herd, are the primary emotions underpinning investment decisions and business strategy, as countless academic studies have shown.

Brian Gaynor, Milford Asset Management executive director and *Herald* columnist, says "fear and greed are the two most powerful sentiments as far as investors are concerned. Individuals with the appropriate combination of these two features should be good investors".

The necessary proportion of fear was plainly absent from the emotional palette of many investors who ploughed their life savings into finance companies sunk by related party lending, property-heavy portfolios and, in some instances, criminality. The credit crunch may have sealed the deal but it's important to note that finance company woes preceded global events.

Greed was plainly a factor in poor decision-making, as was herd behaviour - everyone was piling into finance companies for the extra couple of percentage points above fixed interest investments.

Get in or miss out was the market sentiment. But where was the fear in both company executive and investor?

Ernst & Young Auckland managing partner Simon O'Connor cannily notes that the pricing of risk to meet market expectations was a key factor.

If companies had priced the risk at an appropriate level of, say, "18 per cent, they'd have got less money", O'Connor contends. "Ironically they had to pay lower rates than they would have to attract the money."

Fear was present - but would only kick in at elevated levels of return.

Greed dictates that some money will always chase the higher returns, with the commensurate risk of losing the lot, but in New Zealand every risk was priced the same.

One dollar given to Bridgecorp was virtually the same as parking that dollar in Rabobank. Except that the latter is still giving investors a return and the former is bust.

The misalignment of interests and assessment of risk is also a fault highlighted by Harvard University professors Lucian Bebchuk and Holger Spamann in their analysis of the financial crisis.

Bankers allowed greed to dominate investment decisions because they were shielded by their employer's compensation arrangements (for instance, Merrill Lynch awarded US$3.6 billion in bonuses before its US$15 billion loss and subsequent purchase by Bank of America) and the correct assumption the taxpayer would bear the burden of catastrophic failure, Bebchuk and Spamann argue.

In this scenario, fear has been priced out of the equation.

Greed has also traditionally been seen as stronger than fear, at least by economists and academics, in terms of market motivation. These people conduct social experiments such as the "prisoner's dilemma" and "greed dilemma", which seek to demonstrate why people make decisions that are not in their best interests to do so.

A rational player will co-operate with his or her counterpart to reduce the chance of both losing while others risk catastrophe in the hope of a much bigger personal payoff.

Christchurch University economics senior lecturer Eric Crampton puts it like this: "If folk are behaving rationally, then there shouldn't be much difference between your greed motive to get $100 and your fear motive to avoid losing $100. Greed is kind of just fear with a minus sign attached."

But as other behavioural studies have shown, investors are often more afraid of losing $100 than winning the same amount, he says.

This aversion to loss is one reason why investors hang on to stock in the vain hope that their judgment will be vindicated. Fear can be just as destructive to investor wealth as unrestrained greed.

Of course, fear or greed is not the sole determinant of investors' decisions. In some instances, people display a strong altruistic streak.

Research in the field of neuro-economics suggests aversion to economic inequality is as strong as loss aversion and may be genetic, not only in humans but primates too.

To test this, two groups of monkeys were given cucumbers to eat. When the second group was upgraded to grapes, the cucumber-eaters (the poorly paid) went on a hunger strike. A rational

economic decision would have been to continue to eat your greens and express dissatisfaction in other ways.

But rather than put up with the inequity, the cucumber-eaters preferred to starve.

This finding might come as a surprise to British politician "Red" Ken Livingstone, who in his biography Citizen Ken, argues that the move to an agriculture-based society signalled mankind's fall from a "co-operative utopia ... the basic motive force is greed and exploitation, which is there from the start once you move away from that co-operative group".

Livingstone says: "We haven't learned to cope with surpluses and distribute them without greed becoming the major motive factor and the desire for power over others.

"I do not think that is a natural state for humankind to be in."

Plenty of people argue that the natural state of the kinder, gentler sex is a necessary brake on male risk-taking. Men, it is supposed, are more motivated by greed and women by fear.

Research showing men and women are slaves to biological destiny are ubiquitous. This year, several studies showed how testosterone levels surge in men working on financial trading floors. This may explain why male traders took unbelievable risks before the global crisis.

But women are also hooked on the hormones, if the University of California economics department paper, Menstrual Cycle and Competitive Bidding, is to be believed.

"We show that on average women bid significantly higher than men during menstruation and the premenstrual phase and that there are no significant differences of bidding between men and women in the other phases of the menstrual cycle," Professors Matthew Pearson and Burkhard Schipper report.

Today, New Zealand's economic recovery is limping along and fear is plainly the ascendant emotion.

And it is at times like these, Buffett reminds us, when men and women wanting to make serious money should get greedy. Best of luck.