

Investing and Bishop Berkeley's Tree

George Berkeley, an 18th century Irish philosopher, was famous for his dictum "to be is to be perceived." While his name adorns a venerable university in California, his work is perhaps best known for giving rise to the riddle "if a tree falls in the forest, but no one is around to hear it, does it make a sound?" Dr. Samuel Johnson, finding Berkeley's immaterialist philosophy non-intuitive, exclaimed "I refute it thus!" while hurting his foot by kicking a large rock.

Dr. Johnson's refutation notwithstanding, Bishop Berkeley's philosophy is applicable to the way investors think about risk and returns in the financial markets. In academic theory, financial market volatility is negative but necessary – intelligently assuming risk is the only consistent road to investment returns greater than those of T-bills. Investors therefore should figure out what they want and then invest to achieve the returns they need while assuming the risk they can endure. Of course, in the realm of academic theory, all investors are perfectly rational utility maximizers, there are no taxes or costs and leverage is freely available.

Back on planet earth, we have a few issues with this, even though academic theory provides the structure and framework for our investment process. In our experience, investors are most concerned with direction, not volatility. Clients do not complain when their account is gaining value too fast, nor will they tolerate without complaint a slow, non-volatile erosion of portfolio values. In addition, do people seem perfectly rational to you? If you need convincing, try to analyze the logical flow of a conversation between your friends or even the next speech of the Federal Reserve chair. Far from being effective utility maximizers, the typical investor has actual performance that severely lags the performance of the instruments in which they invest, primarily because of bad market timing – buying high and selling low. Volatility harms this typical investor because it tugs at emotions and encourages bad behavior.

Returning to Berkeley's insight, if investors do not perceive the returns and volatility connected with an investment, do the returns and volatility exist? For example, for many decades people made a lot of money from owning their homes. Yes, there are tax advantages and the ability to obtain a mortgage for 90 percent of the value, but in large part, their success resulted from the price of their house not being in the paper every day. The homeowner could not perceive the returns from or volatility of their home values. If you bought a stock with only 10 percent down and it was bouncing up and down with the economic cycle, you soon would suffer from ulcers. Because the volatility in housing prices was unperceived, however (and, even better, people typically did not think of their house as an investment at all), homeowners were able to capture the increase in value over the long run. They perceived their return only when they sold their house, and they blissfully were unaware of any previous ups or downs in the value.

*"We don't see things as they are.
We see them as we are."*

- Anaïs Nin

This presents us with an interesting paradox - investors desire transparency, low fees and costs, liquid markets and current price quotes. When investors obtain those desirable elements, though, their perception of the volatility of their investments drives them nuts, leading to terrible performance.

Back to the housing market, recent problems stem in part from the new availability of information on home prices. The ability to better perceive current home values led to the availability of mortgages and home equity credit lines based on the now-recognized increase in values. The prior placid environment with only vague notions of home values changed to a situation where there was obsessive focus on year-to-year and even month-to-month changes in the homes prices. Instead of housing being an unperceived tree in a remote forest, there now was a huge audience aware of its fall.

Other sectors of the financial world face the similar circumstances. For decades, many private equity investors earned good returns in relative obscurity, helped by a booming economy, easy availability of credit, management expertise and the premium paid for foregoing daily liquidity and pricing. Partnership reports typically listed investments using an uninformative "lower of cost or bankrupt" accounting convention. Private equity and venture capital investors had little idea of the current value of their investments, let alone fluctuations in that value. Now that private equity is a hot topic and money has flooded into the partnerships, the private equity tree is no longer lonely in the investment forest. As a result, the median private equity investor has not earned superior returns. If you bid up prices so you no longer receive the premium for lack of liquidity, the market does not automatically give the premium return to you anyway. Hedge funds are another example - many of the managers are secretive about the nature of their investments, so it is hard to perceive the underlying volatility.

We have a different take on this phenomenon. Lack of transparency, high fees and costs, illiquid markets and unavailability of price information are still vices, not virtues. Sure, there are superior private equity and hedge fund managers, just as there are superior mutual fund managers, but they still would be superior without the drawbacks. Subjecting yourself to those vices is akin to committing a felony as part of a weight loss program. Yes, the prison food may shed unwanted pounds, but there is an easier way. You can overcome destructive investing behavior with planning and emotional discipline. We disclaim any expertise in forestry, but we can help with the planning and discipline. Call us at (503) 419-3938 or check www.sigmainvestment.com.