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Fast Money and Tiger Woods

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Reading some of the coverage of the [Raj Rajaratnam case](#) – the billionaire hedge fund manager recently convicted of insider trading – I was struck by its relevance to the long-term investing we practice at the Trust Company.

On the face of it, I imagine that sounds rather odd. After all, we don't pay McKinsey partners or Goldman board members to pass on insider tips gleaned from private conversations, and we like to own businesses for long periods of time, rather than trade them based on quarterly earnings reports.

But the Rajaratnam case highlights just how brutally competitive the market for short-term returns has become. There are hundreds of billions of dollars chasing information that might help get an “edge” on what a security will do next week or next month. Investors (legally) hire investigators to count cars in company parking lots, watch foot traffic in stores, or uncover the amount of components being ordered by a hot hardware company. And some investors, it appears, resort to illegal insider tips to get their “edge.”

What makes all this so fascinating is that the investors chasing short-term returns have chosen to play in such a hyper-competitive arena. This is befuddling to me, since the central goal of active money management is to exploit inefficiencies in security pricing, and a heavily competitive market should by definition be more efficient. Why choose to play a game that's harder to win?

As Warren Buffett said a few years ago, “How do you beat Tiger Woods?” The answer is easy, “Don't play him in golf.”

Like playing a round of golf with Tiger, the market for short-term returns is simply more competitive than the market for long-term returns, and more competitive markets offer lower odds for success. There are far more investors trying to guess what Abbott Laboratories' earnings per share will be next quarter than there are investors thinking about how much cash flow Abbott Labs will generate two years from now.

Of course, the history of financial markets shows us that arbitrage opportunities – less efficient markets – tend to attract competition that reduces the opportunity to exploit inefficiencies. In fact, this is exactly what caused Long-Term Capital Management (remember them?) to blow up 13 years ago. They made tons of money taking advantage of a specific type of mispricing in the bond markets, but then other traders got wise to the opportunity and poured in capital, cutting into Long-Term's profits. The competition forced Long-Term further afield into the less-familiar territory that ultimately brought it crashing down.

So, why has capital continued to pour into the hotly-contested market for short-term returns – witness the recent rise of high-frequency traders who may own securities for only a second or less – rather than into longer-term investing, where the opportunities should be greater?

This behavior may defy the abstract economic logic that less-competitive markets should attract more capital, but it's explained by a much more visceral logic rooted in how our brains are wired. First, anticipating short-term financial gains encourages the flow of dopamine -- a neurotransmitter associated

with intense feelings of well-being -- in our brains. (Dopamine is sometimes called “the pleasure chemical.”) Without getting too far into the weeds of behavioral finance, humans seem to be hard-wired to make short-term decisions.

Couple this pre-disposition to short-term behavior with another well-documented psychological trait called “loss aversion,” – the human tendency to prefer avoiding losses to acquiring gains -- and we begin to see why so much capital pursues quick financial profits. If you purchase a security with a one day or one-week time-horizon, not only do you satisfy your brain’s desire for dopamine, but you also reduce the amount of time you need to experience a losing position, if the trade goes against you. From a behavioral standpoint, those are attractive attributes.

But if you have a three to five year time horizon when you purchase a security, you’ve not only “cheated” your brain of some dopamine, you’ve also created the possibility that you’ll need to experience an unrealized loss for a while as you wait for the market to recognize a security’s intrinsic value. Psychologically, these are both hard things to do.

These human frailties are, in my opinion, the reason why the market for long-term security returns is less competitive and less efficient than the market for short-term returns. Best of all, this inefficiency will remain in place until the majority of investors become far more rational than they are today.

So, thank you, Raj Rajaratnam. You and the rest of the fast-money crowd make the lives of long-term investors so much easier. While you appear to have pushed the envelope too far, and have apparently received your just deserts, you are emblematic of an entire industry devoted to seeking out information (mostly legally) that might create a short-term edge.

Those of us who view stocks as small pieces of a business, rather than “little blinking things with charts attached,” will continue to make money by buying securities for less than their intrinsic value, and patiently waiting for that value to be realized.

We do miss our dopamine, though.