



Bad Habits and Good Practices

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Overview

Many investors may think they are well diversified and well positioned to maximize returns, but do they understand the systematic behavioral biases that may be influencing them? These biases result in bad investment habits of multi-year return chasing, underdiversifying and seeking comfort in investment selection. This research uncovers bad practices that negatively impact optimal investment performance, offers behavioral explanations and suggests ways to overcome them.

Practical Applications

- **Don't chase multi-year returns.** Asset momentum investing works, but only up to 12 months. After that, mean reversion is more typical over multi-year horizons.
- **Adopt a multi-strategy approach.** You will avoid the common overreliance on equity market direction.
- **Come out of your comfort zone.** Embrace tools like leveraging or derivatives to fully diversify, but understand the risks and costs.
- **Unearth your behavioral biases.** Separate bad investing patterns from good, and educate yourself on the true drivers of investment returns.

Practical Applications Report

Major pension funds and institutional investors have been increasingly vocal in their support of maintaining a long-term investment horizon, but this research shows that they need to be “good investors” in order to achieve optimal risk-adjusted returns over the long term. Investors don't necessarily recognize that they need to overcome behavioral biases that may lead them to succumb to bad habits like multi-year return chasing, under-diversification and comfort seeking, says **Antti Ilmanen**, Principal at **AQR Capital Management** in London.

“We need to make investors behave better mainly for themselves but also for us (as managers),” adds Ilmanen, speaking about his article, *Bad Habits and Good Practices*, in *The Journal of Portfolio Management*. Ilmanen is co-author with **David Kabiller**, Founding Principal of AQR Capital Management in Greenwich, CT, and **Amit Goyal**, Professor at the **University of Lausanne** in Switzerland.

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“The problem isn’t that investors act as momentum investors over a multi-month horizon, it’s that they act as momentum investors over a multi-year (reversal) horizon.”

—Cliff Asness

Recognize that it **IS HARD** to maintain a long-term investment horizon.

AVOID THE FIRST BAD HABIT

“Multi-year return chasing is the primary problem for investors,” Ilmanen says. This isn’t the same as short-term momentum investing of up to one year, which is an acceptable strategy, he adds. He recalls a quip by his boss, AQR Founder and Managing Principal **Cliff Asness**: “The problem isn’t that investors act as momentum investors over a multi-month horizon, it’s that they act as momentum investors over a multi-year (reversal) horizon.” In other words, investors tend to buy winners too long after they’ve performed well, and sell losers after they’ve suffered a loss.

“A key takeaway for investors: ‘After one year, don’t chase returns,’” adds Ilmanen, whether for asset classes, strategies or funds.

Most institutional investors understand the multi-year horizon doesn’t hold up for momentum investing, but it’s very difficult for them to avoid getting emotionally caught up in a rising market environment, Ilmanen adds. You have one strong year, followed by another and another, and so on.

Institutional investors tend to focus on a three- to five-year investment horizon for performance evaluation, and boards and consultants tend to judge investment manager records on that basis. It’s understandable that investors find it hard to retain a manager or adopt a strategy that’s recently underperformed, even if academic research argues that performance evaluation should be done over much longer periods, the authors point out.

UNDERSTAND INVESTING PATTERNS

The authors offer a number of examples of procyclic investing—selling near bottoms and buying near peaks—from a range of academic studies, covering retail and institutional flows in single stocks, asset classes and mutual funds. They also draw on research by Ang, Goyal and Ilmanen (*Asset Allocation and Bad Habits*, in the **Rotman International Journal of Pension Management**, 2014) showing how pension fund target policy weights chase multi-year returns and exhibit one-year momentum and multi-year reversal tendencies across asset class returns.

“We believe any list of the behavioral biases that might explain multi-year procyclic investing surely starts with extrapolation, our millennia-old tendency to learn from patterns and expect their continuation,” explain the authors. “Procyclic actions are reinforced by various social effects—herding, conventionality, peer risk—and even by certain risk management rules, such as VaR-based position sizing, stop-loss triggers and drawdown control.”

DO YOUR HOMEWORK

“Learn from data and from market experience,” Ilmanen advises, in order to be wary of procyclic investing and maintain the appropriate long-term investment horizon.

“The start of ‘good’ practice would be to recognize that it *is* hard to maintain a long-term investment horizon,” he adds. But investors must do their homework on a new asset or strategy *before investing* to really commit to a long horizon, he adds.

“How do you make your investors more patient?” Ilmanen asks. First, education. “We try to get all parts of the (investor’s) firm to understand the strategy so



there's less overreaction to any underperformance," he says. Second, understand that any investment idea will have a period of underperformance. Going by historical experience and basic statistics, Ilmanen says, even for an exceptionally good strategy, about every fourth year is a down year; for every decade, there's a three-year window that you may lose.

OVERCOME THE SECOND BAD HABIT

Despite the widespread belief in the benefits of diversification, institutional investors tend to underutilize diversification or are not adequately diversified in various ways, the authors note. For instance, many institutional portfolios tend to be overconcentrated in equity market risk, and they may suffer from home bias, Ilmanen says. "Investors are more forgiving of equities for a few bad years versus various alternative investments," he adds. "It's familiar and convenient to stay equity concentrated," he says, even if it isn't the optimal diversification strategy.

...GO THE MULTI-STRATEGY ROUTE

Studies of historical market returns demonstrate that there are periods of underperformance, so investors need to account for the fact that every investment strategy involves some danger of capitulation over time, he points out. Instead, "create a better balanced multi-strategy portfolio that will give investors more patience to hold steady for the long run," Ilmanen advises.

GET OUT OF YOUR COMFORT ZONE

The third bad practice that the authors point to is the bias toward "comfortable" or familiar assets or securities. These investments are often overpriced and therefore deliver lower long-term returns, they warn. The way to get past this comfort zone bias, is to consider leveraging, shorting, or investing in derivatives in order to improve risk-adjusted returns, Ilmanen advises. Of course, some institutional investors may face leverage and other constraints, but if permitted, these strategies can add value. Of course, their risks and costs should be carefully managed.

Setting core investment beliefs and then sticking with them in a consistent manner is key to overcoming some bad investment habits, Ilmanen says. "If investors have stronger convictions, they can behave well (over the long term)," he says. "Whatever you believe, try to figure it out and then stick with it."

As Exhibit 10 in the article shows, each "bad habit" can be overcome by "good practice."

Bad Habits	Good Practices
Chasing Multiyear Returns	Investing Strategically
Under-Diversification	Diversifying Risks Aggressively
Seeking Comfort	Accepting Discomfort When Paid To Do So

The authors recommend: Investors need to spend even more time evaluating the merits of a strategy (or a manager) before investing and only select the ones in which they truly have faith. That is, investors should consider decision criteria (e.g., people,

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Other bad habits:

- ✓ Poor governance standards
- ✓ Inadequate attention to costs

philosophy, process) other than past performance and develop a fuller understanding of the reasonable range of outcomes.

WE'RE IN IT TOGETHER

The authors decided to shed light on the bad practices that can become habits for many investors because investor behavior is as important as the investment strategies that they pursue. The first sentence of the article came from Kabiller: “Good investing results require both good investments and good investors.” Although they focus in the article on the three most prevalent bad practices, there are others, such as poor governance standards and inadequate attention to investment costs, Ilmanen adds.

Adopting good investing practices is far from easy, the authors caution in their research introduction: “... we have spent our careers also battling these same bad habits in ourselves—so our perspective is fully intended as commiseration and shared experience, not as lecturing.”

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Over the years, he has advised many institutional investors, including Norway's Government Pension Fund Global and the Government of Singapore Investment Corporation. Antti has published extensively in finance and investment journals and has received a **Graham and Dodd Award** and **Bernstein Fabozzi/Jacobs Levy Awards** for his articles. His book **Expected Returns** (Wiley, 2011) is a broad synthesis of the central issues in investing.

Antti recently scored a rare double in winning the best-paper and runner-up awards for best articles published in 2012 in **The Journal of Portfolio Management** (co-authored articles **The Death of Diversification Has Been Greatly Exaggerated** and **The Norway Model**).

Antti earned MSc degrees in economics and law from the University of Helsinki and a PhD in finance from the University of Chicago.



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David has co-authored papers on such topics as derivatives, enhanced indexation, securities lending, insurance-linked securities, hedge funds and the secret of **Warren Buffett's** investing acumen. He is a member of Northwestern University's Board of Trustees, Chairman of the Executive Council of the **Northwestern's International Institute for Nanotechnology (IIN)** and has been a guest lecturer at the Kellogg Graduate School of Management and Harvard Business School. He is a member of the Advisory Council of the **AQR Asset Management Institute at London Business School** and also serves on the Board of Trustees for the **Terra Foundation for American Art**.

He founded the Kabiller Prize and the Kabiller Young Investigator Award for researchers in nanoscience and nanomedicine and established NU for Life, a program dedicated to the professional development of Northwestern student-athletes. David earned a BA in economics and an MBA from Northwestern, where he received an athletic scholarship to play tennis and was named to the Big Ten's Academic All-Conference team. He is a CFA charterholder.