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Bitcoin phenomenon illustrates importance of rational investing

ON INVESTING
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As of this writing, cybercurrency Bitcoin has appreciated in value in excess of 1,500 percent so far this year. That makes it one of the best performing investments ever, even when considering tulip bulbs in 1636, stock in the South Sea Company in 1720, and internet stocks in the late 1990s.

Most of the academic studies written on financial markets start with a few basic premises: investors are rational, they want to maximize returns, and they want to minimize risk. Is it possible that the move in Bitcoin is a rational response to new data that has emerged over the course of the past year? Probably not. Bitcoin remains largely the same from a structural standpoint today as it did a year ago.

A more probable explanation for the meteoric rise is that Bitcoin can't actually be valued. There are no cash flows to discount, no comparable tangible assets to measure against, and no earnings to put a multiple on. That pretty much just leaves the greater fool theory as a valuation methodology.

Bitcoin may still have a place in the global economy, and may find a reasonable valuation equilibrium, but like art, gold, antiques, collectibles, wine and rare instruments, there is no objective price that can be set. The job is thus left to human discretion and emotion.

Leaving the valuation of any investment to the whims of the masses seems like a bad idea. However, no matter how rational we may view ourselves, human emotion creeps into the valuation of every security, even stocks and bonds. We may try to assess "fair value" for a stock or bond using methods that we believe have scientific rigor behind them, but no model has yet been able to fully capture the fluctuations of stocks, bonds, currencies, or commodities.

The impact of human emotion on the capital markets has turned into a relatively new field of study called behavioral economics. While it has taken a while to catch on, the most recent winner of the Nobel Prize in Economics was a behavioral economist from the University of Chicago named Richard Thaler. Interestingly, Thaler did his postgraduate studies at the University of Rochester.

Research by Thaler and other behavioral economists indicates that most human beings suffer from cognitive biases that cause us to act in irrational ways. Unfortunately, this doesn't do us any favors when it comes to our finances.

Financial market research firm Dalbar Inc. studies the decisions of individual investors and measures the subsequent results. The news is never flattering. Individual investors, according to the studies, are their own worst enemies. The gap in returns between what individual investors realize and what the stock market provides, is often in excess of 5 percent annualized. One of Dalbar's recent studies notes that "no matter what the state of the mutual fund industry, boom or bust, investment results are more dependent on investor behavior than on fund performance." The study goes on to say that those who hold their investments for the long run tend to outperform those who try to time the market.

Dalbar is not alone. Finance professors Brad Barber and Terrence Odean have also studied the behavior of individual investors and report similar findings. Specifically, they find that individuals underperform market benchmarks, sell winning investments too early and hold losing investments too long, are heavily influenced by past performance, continue to make the same mistakes over and over, and hold stock portfolios that lack adequate diversification. All of this leads to undue risk and poor returns.

The investment industry regularly cites these studies as evidence that individual investors should hire a professional to help manage their investments. Interestingly, the performance record of professional investors is not a lot better than that of individual investors, but that is a topic for a future article.

The reason investors post such poor returns is not because they are inept at picking stocks, but rather because their emotions take over. Fear and greed can be strong motivators, but they are not associated with rational behavior. Those who felt they missed out on the runup in technology stocks in the late 1990s were not thinking about valuation levels and downside risk, they merely wanted to hop on the gravy train. Similarly, when markets are crashing, investors often don't consider whether they should be holding, or even buying more, they just want to stop the pain by getting out of the markets.

That has implications for today's investment environment, regardless of whether you're considering stocks, bonds or even Bitcoin. Investors need to think about why they are investing. Is the investment truly a long-term commitment with solid odds of success over time, or a speculative position that could go up or down significantly in the short run?

For example, think about the IPO of Pets.com in February 2000. The company had the top ranked ad (remember the sock puppet?) by USA Today, and internet stocks were in vogue. It looked like smooth sailing to big gains when the stock came public at $11 per share. However, it dropped to $0.19 per share in November of the same year, a stunning 98 percent loss.

While there are certainly plenty of short-term success stories as well, a better approach is to focus on diversified investments in sustainable entities with solid long-term cash flows, which are likely to produce gains over time. It is possible to remain sanguine and rational even during a sharp short-term market correction with such investments. However, playing in speculative instruments can result in emotional decisions as fear and greed take over. This is what results in the return gap that Dalbar reports.

The solution is obvious: ignore your emotions and focus on long-term, rational behavior. The studies are clear that short-term trading, market timing, following hot tips, and speculation on ultra-risky investments are a recipe for underperformance at best, if not significant losses. Stick to the basics of diversification, long-term investing and driving down investment-related costs.

So, as you watch Bitcoin climb to new highs, technology stocks achieve loftier valuations, and dream about that hot IPO that you could get in on, consider whether your behavior will land you on the investment naughty list.

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