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A Whole Lotto Luck

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Millions of Australians queued up recently for a chance to scoop the nation's biggest jackpot lottery draw. As a demonstration of hope over experience, it carried uncanny echoes of how many people approach investing.

Statisticians pointed out that the chance of winning the $90 million first division prize in the Oz Lotto draw was one in 45 million. Essentially, entrants had more chance of dropping dead the following day or winning a gold medal at the Olympics than they had of getting first prize.

While most treated their flutter as pure entertainment, others took seriously published strategies such as buying their tickets at certain "lucky" stores, basing their numbers on what had won before or consulting a numerologist.

For anyone who has watched investors try and fail to "beat" the market, the behaviour of the more tragic lottery enthusiasts seemed strangely familiar.

There were the traits of overconfidence, hindsight bias and overreaction to what in reality were random events. There was the illusion of control, the elevation of the notion of skill over luck and a blind belief that they alone had an insight into how to work the system. Most of all there was a refusal to recognise that the odds were hugely stacked against them.

One statistician[1] pointed out that a ticket holder had more than a 99.99997796

around the country, fired up by the belief that any chance — even one so extremely remote — was better than none.

This was analogous to investors who cherish the notion that they — or their advisors — have the unique skill of picking stocks and money managers that will consistently deliver them a market-beating return, after fees and taxes.

The futility of this approach to investment has been shown up in countless studies over the years. Most recently, researchers at the Australian Prudential Regulation Authority[2] found in the five years to 2006, the average traditionally managed Australian superannuation fund underperformed its benchmark index by 0.9 per cent each year.

Traditional management, in this case, refers to those managers that are hired to exploit perceived market inefficiencies through tactical asset allocation or market timing and through selecting or over-weighting particular securities. Essentially, these managers are making forecasts.

The APRA study found that on average, the value added by these techniques appeared to be statistically unable to overcome the higher costs associated with attempts to exploit market inefficiencies.

But like the forever hopeful crowds lining up at the nation's newsagents, people just keep on trying. And a very large industry makes a nice profit from their illusions.

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[1]'It's Odds-On You'll Wind Up a $50M Lotto Loser', *The Sydney Morning Herald*, June 23, 2009

[2]'Investment Performance Ranking of Superannuation Firms', Wilson Sy and Kevin Liu, *Australian Prudential Regulation Authority*, June 23, 2009

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