Rothschild & Co
Wealth Management

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Making better investment decisions

Foreword

It's difficult to know how many decisions the average person makes in a day. Experts estimate that the number could be anywhere between 10,000 and 40,000[1] – the equivalent of at least one every two seconds.

If the latter is true, you'll have already made three or four choices while reading these opening paragraphs. That may seem far-fetched, but it's not completely outlandish.

You'll have decided whether to keep reading after the first couple of sentences, for example, so thanks for sticking with us this far. Perhaps you also chose to take a sip of coffee or check the time? Maybe you decided to do none of those things.

The reality is that we're constantly making decisions, whether we're aware of them or not. And despite considerable research, the reasons behind how and why we make certain choices remain somewhat of a mystery, even to ourselves.

What we do know is that making big decisions is difficult.

The more we have to make, the more decision fatigue becomes a factor, diminishing the quality of our choices. If we have too many options, analysis paralysis can also be a problem, preventing us from making any decisions at all, let alone good ones.

As wealth managers, we understand that our choices are important. Our investment decisions aim to preserve and grow your wealth, so that you can then make crucial decisions about your family's future. It's not a responsibility we take lightly.

In this *Quarterly Letter*, we'd like to illustrate how much thought goes into our decision-making, in the hopes that you can remain confident in your decision to trust us as the custodians of your wealth.

Helen Watson
CEO, Rothschild & Co Wealth Management UK

[1] 'Decisions, Decisions, Decisions – Is the Concept of Decision Fatigue an Issue in Covid-19 Times?', Rita Symons, BMJ Leader, 6 May 2020

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Making better investment decisions

Crystal Palace Park in south-east London is home to one of the UK's most unusual Grade I listed buildings. Tucked away next to a boating lake, not far from the park's southern entrance, is Dinosaur Court.

What makes Dinosaur Court different to other listed buildings is that it isn't a building at all – it's a collection of 30 sculptures. Commissioned in 1852 and created by esteemed natural history artist Benjamin Waterhouse Hawkins, they include the first full-scale reconstructions of dinosaurs.[2]

Despite Dinosaur Court's name, only four of the sculptures are modelled on actual dinosaurs, namely a Megalosaurus, a Hylaeosaurus and two Iguanodons. The rest depict other extinct animals from ancient times, such as giant ground sloths and the seven-foot tall Irish Elk.

When originally unveiled, the striking cement sculptures wowed Victorian crowds. It was the first time the general public was able to see the true size and scale of the 'terrible lizards'[3] that had once roamed the earth.

Unfortunately for Waterhouse Hawkins, the sculptures went on display shortly before a frenzied period of activity in the dinosaur world, eventually culminating in the 'Bone Wars'. Further research and the subsequent discovery of many relatively complete dinosaur skeletons quickly showed the sculptures were almost comically inaccurate.

For example, Waterhouse Hawkins had interpreted a spike-shaped bone as a horn, which he placed on the Iguanodons' heads. We now know the 'horn' is actually a thumb. The Megalosaurus is also depicted as walking on all fours, resembling a giant crocodile or monitor lizard, whereas the real dinosaur was almost certainly bipedal, with short forelimbs similar to a Tyrannosaurus Rex.

By the end of the 19th century, the Crystal Park Palace dinosaurs were widely mocked within the palaeontology community. Today, they are still mostly known for their aesthetic blunders.

This reputation is perhaps unfair. Waterhouse Hawkins faced a challenge that many of us will recognise – making difficult decisions with incomplete information.

His designs were typically reliant on just a handful of fossilised bones, so he had to fill in a lot of gaps. And while he made many mistakes in hindsight, he got almost everything right when it came to his decision-making process.

But before we talk more about dinosaurs, let's delve a bit deeper into decision-making within the world of investment, starting with another species from the textbooks: *Homo economicus*, or the 'economic man'.

[2] 'The world's first dinosaur park: what the Victorians got right and wrong', *Natural History Museum*

[3] The word 'dinosaur' derives from 'dinosauria', which is rooted in the Greek for 'terrible' or 'monstrous' lizards.

What makes Dinosaur Court different to other listed buildings is that it isn't a building at all – it's a collection of 30 sculptures.

'ECONOMIC MAN' MEETS A HUNGRY JUDGE

As we said earlier, every day we make decisions that shape our lives. Many are trivial, such as 'what shall I buy for lunch?'. But others are much more important, like asking 'what career should I pursue?'

Most of these decisions, large and small, have some impact on the economy. So for centuries economists have used the economic man as a template for modelling human behaviour in markets.

Economic man is the perfect decision-maker. He's blessed with superhuman powers of rationality, as well as unfettered access to information and flawless foresight – abilities that are used exclusively in the pursuit of wealth and self-interest. He's the ultimate consumer.

A caricature, then, but a useful one for generations of economists who have sought to create mathematical models and equations to calculate how the economy works. But does *Homo economicus* reflect decision-making in the real world?

As an investor, for example, he would know exactly which assets to own and the ideal moment to buy and sell in order to maximise profit and minimise risk. What's more, his choices would never be clouded by emotions or external factors.

This is clearly unrealistic. No one can see into the future, and we instinctively know that people are rarely completely rational. In fact, our decisions are often more arbitrary than we'd like to think.

Take the 'hungry judge' effect, for example. Studies have found that judges are more generous at offering parole once they've had their lunch. In one experiment, the number of prisoners given parole rose to approximately two-thirds of cases after a food break, having slumped to near zero when dinner time was approaching.[4]

Similarly, the phrase 'you change your mind like the weather' is particularly apt for university admissions officers. They are said to be much more likely to accept students with strong academic backgrounds if the weather is cloudy or overcast.

As soon as the sun begins to shine, however, students who are athletically gifted or participate in extra-curricular activities are given the nod more often. Research has shown investors display similar behaviour, being overly optimistic and less risk-averse in sunny weather.[5]

If professionals who spend their entire careers learning critical thinking can be swayed by little more than hunger pangs or some light drizzle, how much faith can we place in the concept of *Homo economicus*?

FROM RATIONAL TO IRRATIONAL

In her 2017 book *Doughnut Economics*, English economist Kate Raworth argues that the time has come to retire *Homo economicus* as a template for decision-making in markets.

Rather than simplify human behaviour down to a perfectly rational (and fictional) consumer, we should instead look to embrace real-world complexity and acknowledge the quirks inherent to how we make decisions.

"Over millennia, the human brain has evolved to rely on quick decision-making tools in a fast-moving and uncertain world, and in many contexts those 'heuristics' lead us to make better decisions than exact calculations would do," Raworth explains.

People are so prone to taking these mental shortcuts that some behavioural experts believe we should replace the term *Homo economicus* with *Homo heuristicus*.

[4] 'Judges are more lenient after taking a break, study finds', *The Guardian*, 11 April 2011

[5] 'Why good weather isn't a good thing for stock markets', *University of Portsmouth*, 5 May 2023.

People are so prone to taking these mental shortcuts that some behavioural experts believe we should replace the term Homo economicus with Homo heuristicus.

Heuristics aren't infallible either, however. The difficult part is recognising when these mental shortcuts are harming, rather than helping, our decision-making process.

For investors, that means accounting not only for the external 'noise' that may affect our choices day to day, but also the deeply entrenched cognitive biases we all hold.

There are many ways our judgement can be swayed – online encyclopaedias list well over 200 different examples.

We won't list them all here, but many people will be familiar with confirmation bias, where information is given much higher value when it reinforces our pre-existing beliefs. It's easy to ignore or downplay negative news coverage of a particular company, for example, if you hold it in your portfolio.

This tendency also overlaps with another common bias – the endowment effect. People are more eager to keep something they already possess than they would be to acquire it if someone else owned it.

Why? It's partly due to loss aversion (yet another bias), whereby the psychological pain of losing far outweighs the positive feelings of winning. In some studies, a loss has been found to be more than twice as impactful as a win.

As a result, people look to avoid losses at any costs, sometimes to their detriment, such as holding on to a bad investment in the hopes it will someday return to profitability.

And for those who think they are immune to cognitive biases and irrational decision-making, you might be experiencing illusory superiority or the 'Ostrich effect'.[6]

A GROWTH MINDSET

We're now aware of the challenges posed by incomplete information, external influences and unconscious biases. But how can we avoid these pitfalls?

According to political scientists Philip Tetlock and Dan Gardner, we can all become better decision-makers if we aspire to a 'growth' mindset. This refers to people who believe their skills and knowledge can be developed through hard work, practice and study.[7]

If that sounds like it applies to everyone, you'd be surprised. Many people have a 'fixed mindset' instead, meaning they view ability as an innate quality that can't be dramatically improved, regardless of effort. We have probably all met someone who is convinced they are inherently 'bad at maths' or 'terrible at learning languages'.

The implications of having these different mindsets have been studied. In one experiment, a group of volunteers underwent brain scans while they answered trivia questions. They were then told whether their responses were right or wrong, along with information on how they could improve their performance.

The scans showed both the growth mindset and fixed mindset participants were fully engaged while they were being told if they'd answered the questions correctly or not. However, only people with a growth mindset continued to listen when they were given tips on how to improve.

For them, being right was important, but learning was the priority.

In their book *Superforecasting*, Tetlock and Gardner say a growth mindset and a willingness to change your mind when new information comes to light are essential to making better decisions.

Tetlock should know. From 1984 to 2003, he monitored the predictions of 284 experts from a variety of fields to see how accurate they were. After 20 years of research and roughly 28,000 predictions, he discovered that most professional forecasts are only slightly better than random guesses – and the more famous the analyst, the less accurate the prediction.

Afterwards, Tetlock set up the Good Judgment Project, which brought together talented amateurs to forecast world events based on media reports and other publicly available information.

The best candidates, the so-called 'superforecasters', reportedly performed around 30% better than intelligence officers who had access to classified information.[8]

"Foresight isn't a mysterious gift bestowed at birth. It is the product of particular ways of thinking, of gathering information, of updating beliefs," says Tetlock.[9]

Put simply, to be better decision-makers, people need to think more like scientists.

[6] Illusory superiority is a tendency to underestimate one's undesirable qualities, while the Ostrich effect is the impulse to ignore negative situations – burying one's head in the sand.

[7] *Superforecasting: The Art and Science of Prediction*, p175-177, Philip Tetlock and Dan Gardner, 2016

[8] 'More chatter than needed', David Ignatius, *Washington Post*, 1 November 2013.

[9] *Superforecasting: The Art and Science of Prediction*, p18, Philip Tetlock and Dan Gardner, 2016.

FINDING THE RIGHT STRATEGY

Scientists are paid to be curious. Their job is to question what they know, test their theories in the real-world and then challenge their preconceptions if their hypotheses turn out to be wrong.

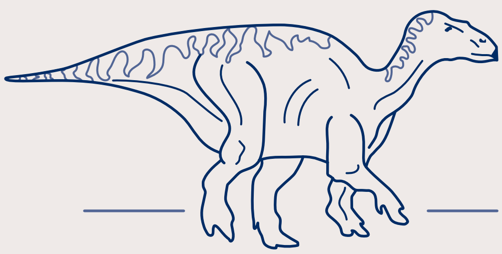
As we discovered earlier, this way of thinking isn't always intuitive. Our cognitive biases and a multitude of external factors are constantly encouraging us to bypass logic and go with our gut – sometimes literally, in the case of a hungry judge.

Yet the benefits of a scientific mindset can be profound. To test whether this way of thinking would help professionals in other fields, European researchers once ran an experiment with more than 100 start-up companies in Milan.

The business owners were at the very beginning of their entrepreneurial journey and most of them hadn't received any revenue yet. They then underwent a start-up training programme, where they were split into two groups. One was taught the scientific method and the other was a control.

LONG IN THE TOOTH

Comparative anatomy is how the Iguanodon received its name. The dinosaur's teeth were similar to modern-day iguanas, albeit 20 times bigger.



All the entrepreneurs received identical training, but the 'scientific' group were told to view their business strategy as a hypothesis, one that should be scrutinised and rigorously tested before commercial decisions were made.

Over the following year, the start-ups in the control group were averaging just over $250 in revenue each. Meanwhile, the science-led group were earning approximately $12,000 – a staggering 4,700% more than their counterparts.[10]

Thinking like a scientist encouraged these entrepreneurs to investigate which products and approaches worked in practice, and they adjusted their strategies accordingly.

Indeed, they pivoted their business model more than twice as often as the control participants, reaping the financial rewards as a result. The control group, meanwhile, were far more likely to stick to a losing strategy, demonstrating loss aversion, and listen to advisers who reinforced the status quo, or confirmation bias in other words.

MIXING ART WITH SCIENCE

The Milan experiment shows that you don't have to be a scientist to think like one. Everyone can do it, even artists.

Let's return to Benjamin Waterhouse Hawkins and his infamous dinosaur sculptures. Given his profession, he can be forgiven for taking some creative liberties in his work. A certain amount of artistic license is to be expected, after all.

Nevertheless, he made every effort to ensure the sculptures were as true to life as possible using a combination of the latest research, his own expertise and the guidance of Sir Richard Owen, one of the era's most celebrated palaeontologists.

Recent fossil discoveries formed the crux of the designs, but there wasn't much to work with. Instead, to flesh out the models, Sir Richard and other dinosaur experts used comparative anatomy to check dinosaur bones for similarities to existing animals. This information was then incorporated into the final designs.

[10] *Think Again*, p30, Adam Grant, 2021

Waterhouse Hawkins was himself an authority on natural history, having studied it from the age of 20. His extensive knowledge proved invaluable, enabling him to make reasonable assumptions on how the dinosaurs would have looked, while adding a dash of artistic flair to bring the designs to life.

The Crystal Palace Park sculptures were therefore a clever mix of art and science. They were the culmination of deep research, subject matter expertise, creativity and partnerships with leading industry specialists.

These ingredients are also key to our investment approach.

CHOOSING THE RIGHT OPPORTUNITIES

At Rothschild & Co, we've sought to create an environment that supports good decision-making. We have a clear goal of preserving and growing your wealth through above-inflation returns over the long term.

Every investment decision we make should be viewed through that lens.

We recognise that our decisions will never be perfect. We believe acknowledging this strengthens, rather than weakens, our investment approach. Being aware of the cognitive biases and external noise that may affect our decision making enables us to counter their effects.

We do this by encouraging rigorous debate and transparency between our teams, with client advisers, portfolio managers and analysts regularly challenging each other's views and preconceptions. Our aim is to foster a collegiate atmosphere, where growth mindsets are valued, while avoiding the perils of groupthink.

Ultimately, like the sculptures of Waterhouse Hawkins, our investment decision-making is part art, part science.

With our scientist's goggles on, we conduct extensive research into every company or fund that we're considering for our portfolios. This involves evaluating past and current performance, assessing profitability, capital allocation and cash flows. Only then can you calculate an attractive price at which to buy.

However, the numbers don't capture the totality of an investment. That's where the art of active management can provide the missing links.

By drawing on the extensive experience and knowledge of our portfolio managers and wider investment team, we believe we're able to better understand the less tangible, more subjective elements of an investment.

We seek to answer questions such as whether an organisation has a strong management team? And if so, is there a detailed succession plan in place for key individuals should they leave? This is important information that can't be found in a spreadsheet or quarterly report.

To supplement our independent analysis, we also liaise with subject matter experts, third-party fund managers, external researchers and former suppliers, employees, distributors and customers of companies. Their input and insights help us paint a more accurate picture of certain markets and investments, just as palaeontologists used Sir Richard Owen to expand their knowledge.

But the final decision on whether to buy or sell an investment always lies with our portfolio managers. To ensure a high level of conviction underpins every decision, we will only buy a company or fund when all four portfolio managers are in complete agreement. On the other hand, we would sell even if only one was confident that it was the right move.

While it may be comforting to believe in the concept of a perfectly rational, flawless decision maker, the reality is quite different. *Homo economicus* isn't just extinct – he never existed.

Instead, the decisions we make – like the world we live in – can be messy, unpredictable and prone to error. But why let perfect be the enemy of good?

With the right research, a more scientific approach and flexible thinking, it's possible to make better, more reliable decisions. We hope that you, our clients, recognise these qualities in our investment approach.

Important information

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance should not be taken as a guide to future performance. Investing for return involves the acceptance of risk: performance aspirations are not and cannot be guaranteed. Should you change your outlook concerning your investment objectives and/or your risk and return tolerance(s), please contact your client adviser. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. Income may be produced at the expense of capital returns. Portfolio returns will be considered on a "total return" basis meaning returns are derived from both capital appreciation or depreciation as reflected in the prices of your portfolio's investments and from income received from them by way of dividends and coupons. Holdings in example or real discretionary portfolios shown herein are detailed for illustrative purposes only and are subject to change without notice. As with the rest of this document, they must not be considered as a solicitation or recommendation for separate investment.

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