

Keynes' Beauty Pageant



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At Kobren Insight Management we often write about the important market factors of valuation and sentiment and how they impact market returns.

In this short article, we will use an illustration that might help bring some of these thoughts on sentiment and valuation together. An important thing to keep in mind is the oft-quoted saying “In the short-term, the stock market is a voting machine; in the long-term, it is a weighing machine.” In other words, the market’s near-term direction is mostly a function of investor sentiment as it is essentially a popularity contest, but that over time, “value will out” as prices and value converge.

There is a brilliant paper called the “Seven Sins of Fund Management” by James Montier (DrKW Macro Research) that was written several years ago. The paper is really more about investment decision-making for all investors, as opposed to simply the management of funds. Montier is the author of one of the leading texts on behavioral finance which is aptly titled “Behavioural Investing.” While the paper (which is over 100 pages long) encapsulates many of my pre-existing notions about how markets work and investors behave, the article clearly expanded and enhanced what I thought I knew. This article is one the many that surround my desk or populate my wall – and has been for years.

Within the article is a chapter dedicated to a contest that Montier calls a “Keynes’ Beauty Contest.” This chapter has a lot of key messages, but I personally think chief among them, it does a nice job of illustrating how sentiment and valuation can impact market returns over time.

Montier refers to a classic John Maynard Keynes (a British economist who is arguably one of the most influential economists from the past century) quote from 1935 which says:

“...investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole...it is not a case of choosing those which, to the best of one’s judgment, are really the prettiest, nor even those which average opinion genuinely think the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be.”

This does indeed sound like what most market analysis is about. In short time periods, it’s not strictly about long-term valuations (if at all), but instead an attempt to game short-term market direction by trying to outguess other investors.

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Montier used a game to illustrate. The game was actually first played in 1995 (Nagel, “Unraveling in Guessing Games: An Experimental Study”, American Economic Review). **The aim of the game is to pick a number between 0-100 and the winner is the person who picks the number that is closest to 2/3rds of the average number chosen.** For example, if there are three contestants and their respective answers were 40, 50 and 60, the average would then be 50. Two-thirds of 50 would be 33. The person who selected 40 would be the winner.

If you were in this contest, how would you answer this question? Montier conducted this study numerous times, and I have asked a few audiences myself. (Some answers below to earlier contests.) The ability to win does depend on a few items. First, how rational does one think his or her competitors are? Also, is the game played once, or are there multiple rounds so one can adjust their later answers?

There is in fact a single rational answer. There is only one number that satisfies the equation $x = 2/3x$. That number is zero. A one round game, however, is extremely unlikely to find that result. A multi-round game will eventually move toward the rational answer – though it usually takes longer than one might expect.

This contest is theoretically very much like market behavior. Short-term, it is a beauty contest where investors try to guess the popular investments in the current environment. Longer-term, however, the rational answer – such as what the prospective yield is on an investment over a period of years – will likely prevail. It does take some time, however, for that answer to be realized.

So what was the typical response in this game? Again, it depends on the study and the quality of players. In the twenty studies in the Montier article, and equal-weighting them, the average response was 29. So the average winning response was two-thirds of that at 19.