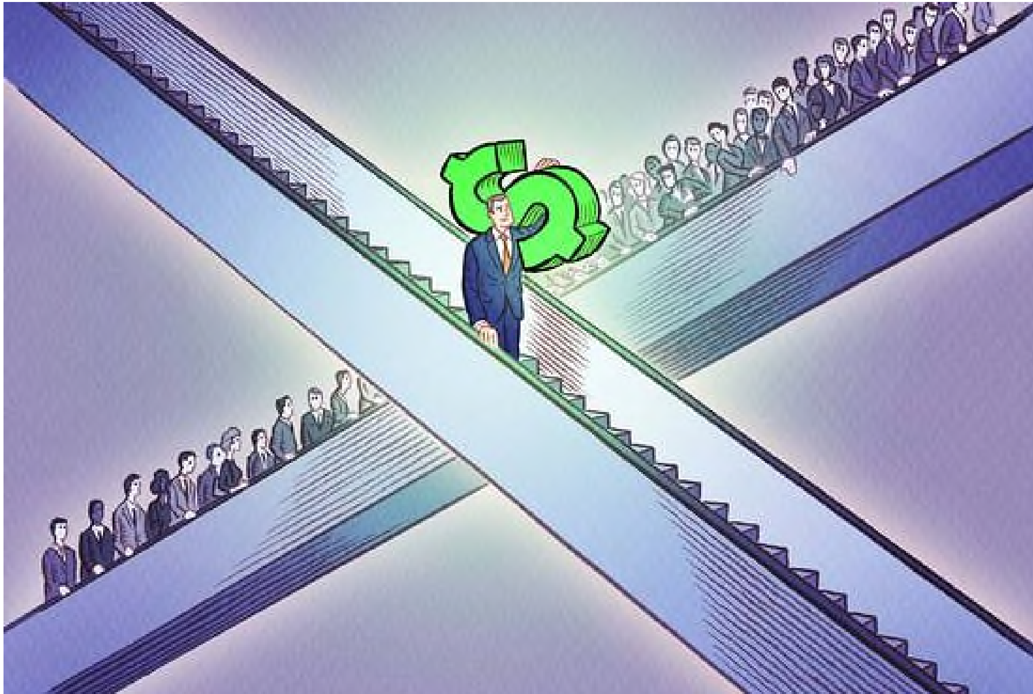
THE WALL STREET JOURNAL.
WSJ.com

April 17, 2015, 1:55 PM ET

Are You Hot or Not? For Investors, It's Hard to Tell

ByJason Zweig



Christophe Vorlet

For an investor, being proved right when others turn out to be wrong can build your confidence. It also should shake it.

That is one lesson from the eye-catching performance of the Wasatch-Hoisington U.S. Treasury Fund. This portfolio, which holds the longest-term, riskiest Treasury debt, was up 32.6% in 2014 and has gained an average of 8.7% annually for the past decade.

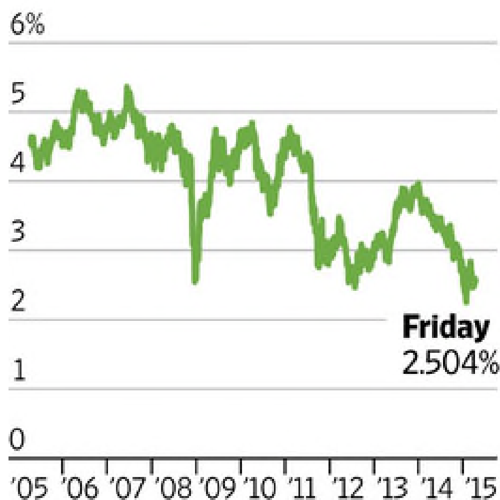
For much of that time, nearly every economic forecaster and bond investor in the country was betting that interest rates had to go up. Van Hoisington, manager of the Wasatch mutual fund and chief executive of Hoisington Investment Management in Austin, Texas, bet that rates would go down. And he still thinks they will—but he is testing and retesting his assumptions.

As well he should.

Being on a hot streak is one of the most dangerous things that can happen to a professional or individual investor.

Now that the S&P 500 has risen 226% since March 2009, including dividends, stock investors also should

worry about how being proved right can undermine their ability to imagine being wrong.



Once the performance of an asset exceeds your expectations, "the position becomes an anecdote," says Michael Ervolini, chief executive of Cabot Research, a Boston-based firm that helps professional investors analyze their decisions. "And the point of the anecdote is that you know exactly what you're doing."

Just think of how the people who owned gold back in 2011 and 2012, when it was selling for $1,400 to nearly $1,900 an ounce, insisted that it had nowhere to go but up. Based on emails I received back then, those who were most vehement that it was on its way to $5,000 were those who had bought it for $1,000 or less. The more money they had already made on gold, the more certain they were that it was on its way to the moon. (Gold traded around $1,200 this week.)

Or think of the folks who bought Internet stocks in 1999 and doubled or tripled their money in no time. Plenty of them were convinced, by early 2000, that nothing else was worth owning. Within 12 to 18 months, many of them had lost 90% or more.

No wonder the economist and investment strategist Peter Bernstein, who died in 2009, was fond of saying, "The riskiest moment is when you are right."

In much of life, doing things right over and over again is a sign of skill; expert musicians, for instance, rarely hit a wrong note. And the skill of one professional musician doesn't make it harder for the others to be equally expert.

But in the financial markets, where so many investors are highly skilled, their actions cancel each other out as they quickly bid up the prices of any bargains—paradoxically making luck the main factor that distinguishes one investor from another.

And a streak of being right can make anyone forget how important luck is in determining the outcome.

Research led by psychologist Ellen Langer, now at Harvard University, shows that when people who predict the tosses of a coin are told they got eight out of their first 10 flips correct, they conclude that they are significantly better than average at calling heads or tails—and that they could get well over half their guesses right if the coin were tossed another 100 times.

Prof. Langer called these incorrect beliefs “the illusion of control.”

If, however, people either get most of their early guesses wrong or win and lose in a random pattern, they don’t believe they have any special gift for calling heads or tails; nor do they remember being correct more often than they were.

Guarding against the illusion of control takes constant vigilance. The longer you’ve been right, the harder it gets.

“We have a meeting every week in which we discuss every write-up we can find on the argument that rates are going up so we know the other side of the coin,” Mr. Hoisington says. “So far, we think the weight of the evidence is still on our side.”

“Our confidence level rarely goes above 60%,” he adds. “We have to pay attention, because we’ll be at the top—in a negative sense—if rates go up.”

Only three out of 992 other U.S. taxable bond funds are more sensitive to changes in interest rates than Mr. Hoisington’s, according to the investment-research firm Morningstar. Based on a measure called “duration,” the Wasatch-Hoisington fund is likely to lose 20.5% of its net asset value if rates rise by one percentage point.

Now also is the ideal time for stock investors to think about whether they, too, are prepared to be wrong. U.S. stocks lost 41.8%, counting dividends, between September 2008 and March 2009. Before you buy more, make sure you are comfortable with the risk of losing roughly half of what you already have.

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