

April 2011: Behavioral Pitfalls that Inhibit Investment Success

By John Goltermann, CFA CPA

"Nothing defines humans better than their willingness to do irrational things in the pursuit of phenomenally unlikely payoffs." ~ Scott Adams

Investment markets and global events are important, but sometimes it's helpful to look inward to understand our own human tendencies and how certain cognitive biases steer our attitude and behavior towards investments. To recognize that these *biases can detrimentally affect our investment behavior* is to enable behavior modification to improve results. This is at the crux of understanding Behavioral Finance.

It is also important to understand *institutional* biases and how institutional investors are motivated because 1) they control significant amounts of capital in financial markets, and 2) the people who control institutional money have very specific incentives, motivations and mandates that *override the effort of purely earning a return*. Their motivations are more about *not getting fired* than about evaluating risk-adjusted returns based on their merits. Knowing this offers advantages for individual investors.

Integral to successful investing is an attitude of humility. We don't claim to know the future and will sometimes make mistakes. However, using our training and experience in accounting, finance and investing, we try to understand asset quality and financial structures, and approximate the valuations of investments. We back into the *expectations* that are priced into various assets, and from there we can generally differentiate between compensated and uncompensated risks – *but they are still risks*. Our process, no matter how detailed and thorough, does not give us the ability to earn consistently better short-term returns than our peers or indices because investment markets move on liquidity and emotions, which are random and unpredictable. Our process cannot prevent unforeseen adverse outcomes, but it can help stack the odds in our clients' favor.

Before addressing specific cognitive and behavioral biases, it is important to be aware of certain elements that we view as truths in the activity of investing and in the *business* of investing:

- 1) People are backward looking at all times. They can't help it because the past is what is *known*, what is observable and is what causes emotional reactions, affecting behavior. But information and events from the past have limited usefulness in predicting the future.
- 2) Investor behavior is different than consumer behavior; investments are priced in a different psychological dimension than are consumer goods. Often, when investment prices are high and rising, people seek *more* of them; when prices are low and falling, people feel anxiety;

they avoid them and seek to *sell* them – the opposite of how we behave when shopping for consumer goods.

- 3) There is no such thing as a “hot-hand” in investment management. Also known as the clustering illusion, it is the idea that prior outcomes have predictive value for successive outcomes. It doesn’t exist in competitive sports such as basketball just as it doesn’t exist in investment outcomes. There are managers with a solid process who can make good calls successively, but *previous outcomes have no necessary correlation to future outcomes*. Despite this, ***people invest as though they do***.
- 4) Volatility and returns are correlated. In other words, unless you’re Bernie Madoff, high returns come with high volatility and low returns come with low volatility – but you can’t have high returns with low volatility.
- 5) Individuals dislike losses disproportionately more than they like gains. This is called prospect theory and it has important implications in investment markets because collective behavior is more about loss avoidance than gain-seeking, which drives perceptions. The absence of declines in real estate prices between World War II and 2007 caused a widely embraced notion that real estate was low risk and a belief that “real estate can’t go down.” This drove a lot of investors into the asset class.

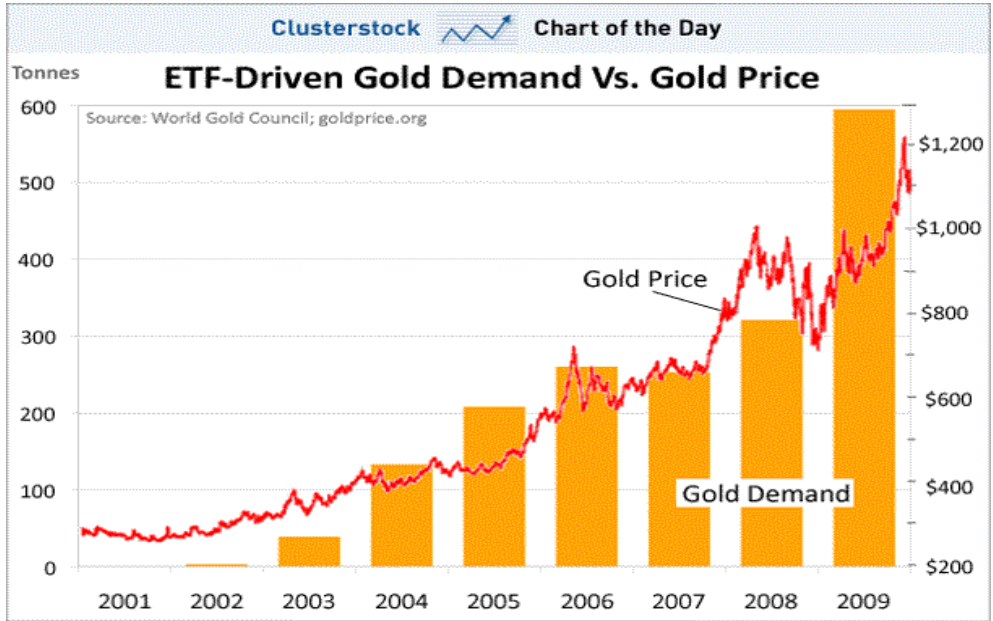
In the activity of investing, *time* and patience are extremely important variables, as is the investor’s awareness of and resistance to the cognitive biases that influence many investors and cause poor decision-making. It is important to know that many, *not all*, investors hire managers or pick investments based on flawed methodologies and illusory elements, which causes pricing distortions. Here are specific cognitive biases that intelligent people fall victim to repeatedly and that often derail their investment success:

Recency Bias: the belief that *recent* outcomes (returns) are more important or relevant than *older* outcomes. When judging a particular investment or investment manager’s performance, the investor looks almost exclusively at the last year or two instead of looking at what happened in, say, 2002. Yet neither year’s outcome has any more predictive information than the other for predicting the next 5 years. Tellingly, a Chartered Financial Analyst (CFA) study showed that when multiple investment managers are interviewed for an engagement with an institutional investor (e.g., an endowment or a pension fund), 90% of the managers that were ultimately selected were those who had the best performance over the last twelve months. This can be explained by *recency bias*, as well as by the *institutional imperative* (see below).

Confirmation Bias: when looking through data, we select the data that provide confirming evidence of the things we believe are true or *want to believe are true*, and discard contradictory evidence. When one buys a stock and it moves up, people often take this as confirming evidence that their original investment thesis was correct; in fact, it is usually just random variability that *happened* to move in their favor.

One example of confirmation bias is one we commonly see among many of our peers in the investment business. Many investment professionals continue to repeat their belief that gold (the “barbarous relic,” to quote Keynes) is in a bubble, or that it *never* belongs in an investment

portfolios. They point to recent flows into gold ETFs as evidence of a speculative bubble (see chart below). But these are many of the same people who scoffed at precious metals investing in 2002 and held up as evidence (at that time) the 20-year price chart as proof that it was a poor investment. Their confirmation bias leads them to overweight the importance of this chart:



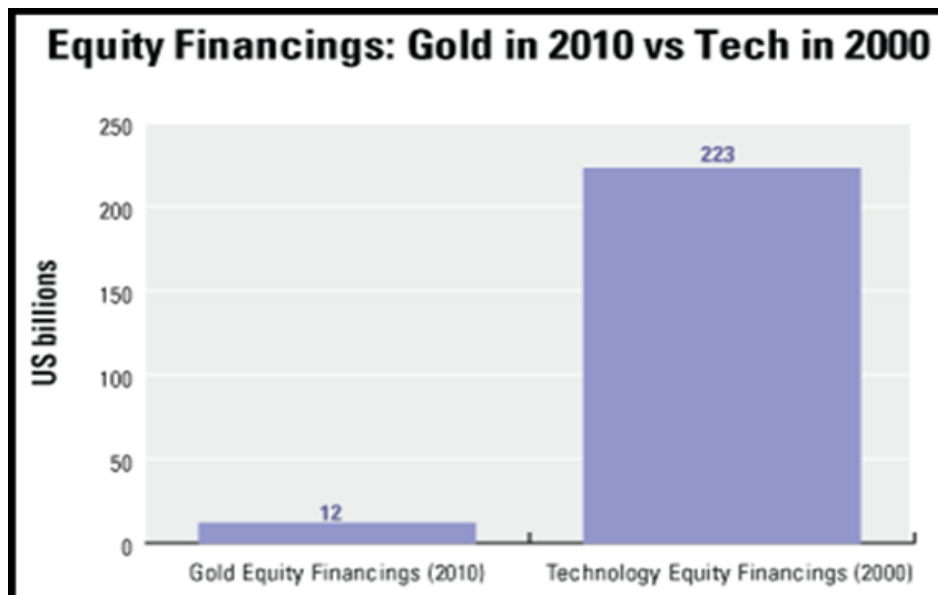
Source: Business Insider, March 17, 2010

At the same time, these investors underweight the importance of this next chart that compares the dollar value of above-ground and below-ground gold relative to the dollar value of total financial assets (many of those being loan pools created to disintermediate credit risk on housing, assorted real estate projects and various other assets):



Source: Erste Group Research, www.silberjunge.de

The chart above begs the question as to what exactly *is* in a bubble – financial assets or gold? Furthermore, the next chart, which compares gold to tech financings, seems to counter the theory that gold is in a bubble:



Source: Sprott Asset Management

Confirmation bias is one of the most dangerous cognitive flaws when it comes to investing and is the source of enormous opportunity costs. Contradictory evidence such as the two charts above will likely continue to be ignored by the vast majority of professional investors because it doesn't fit their narrative. However, at some point as those investors' business risk increases from increasing defections of clients resulting from a refusal to own gold, we could see a capitulation effect and the foundation of an actual gold bubble.

Hindsight Bias: occurs when a person believes (after the fact) that the onset of some past event was predictable and completely obvious, whereas in fact, the event could *not* have been reasonably predicted. For example, many people now claim there were obvious signs of the late 1990s' and early 2000s' technology bubble. If the formation of the bubbles had been obvious at the time, they would not have occurred and eventually burst. As Nassim Taleb, author of *The Black Swan* points out, humans are "very good at predicting the past."

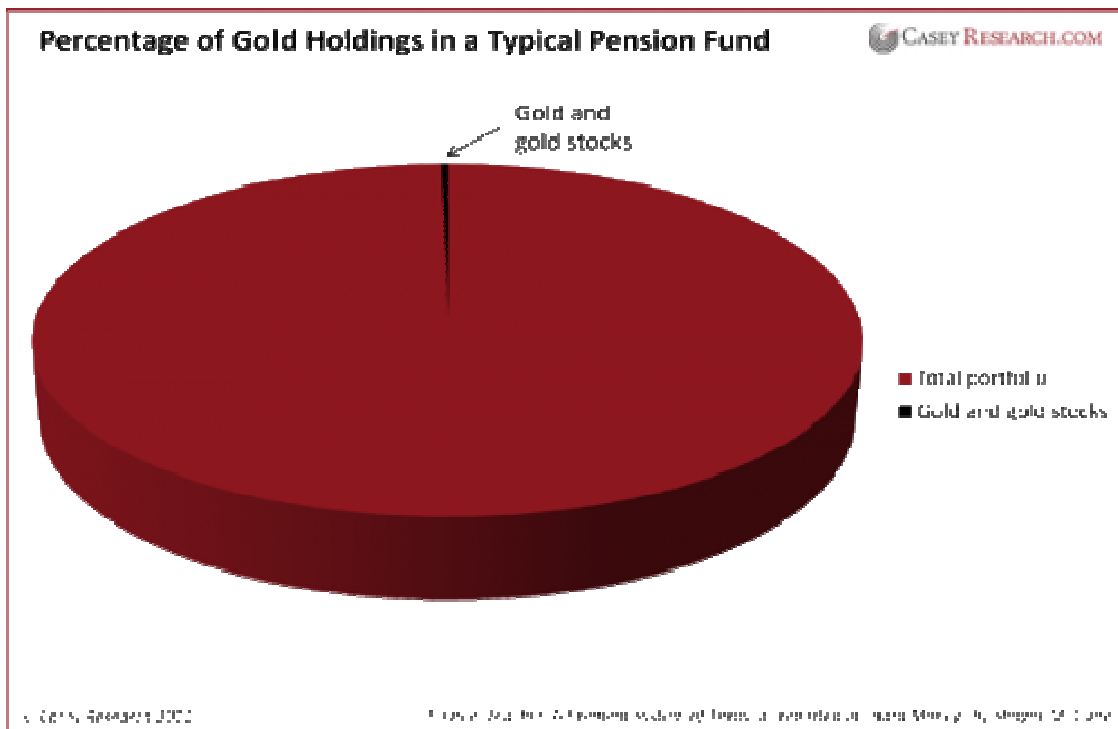
Hindsight bias is the feeling of "I knew it all along." It is why we call investments that end poorly "mistakes." However, mistakes cannot be judged after the fact, *they can only be judged based on information leading up to the decision point*. Because the past is deterministic and the future is unknown, the danger in hindsight bias is overconfidence. Those who are very good at "predicting the past" will see themselves as very good at predicting the future, but their overconfidence leads to a loss of objectivity and poor decision-making.

The Institutional Imperative: the belief among professional investors that, when putting your reputation on the line, it is much more desirable to be wrong with the crowd than it is to be wrong

alone. This leads to a herding effect in investments. Sticking your neck out on a controversial investment call can be a career-ender if it doesn't work out, but owning controversial investments is actually the best thing investment managers can do for their clients.

Backing up the clock again to 2000, many professional investors were unafraid to take a big weighting in Cisco at \$80/share even if it seemed a little pricey (we now know that earnings were grossly overstated) because if they were wrong, lots of people were wrong... which made it OK. That same investor was loath to take a big stake in Berkshire Hathaway because it was a "proven" loser (at least over the previous twelve months and because of Buffett's refusal to capitulate to the tech bubble), and no one wanted to own it. If an investment manager's risk assessment was that there was a 75% chance Cisco would decline 20% and a 25% chance Berkshire would decline 20%, the vast majority would *still* invest in Cisco because defection risk was lower ; being wrong in Cisco was excusable and being wrong in Berkshire was not.

The institutional imperative is manifest in this chart:



Source: Casey Research

Of the estimated \$31.1 trillion of global pension assets at the end of 2010, currently 0.30% is invested in gold and gold-mining stocks combined. That is not a misprint. If the institutional imperative had not been such a major force in the asset allocation methodology of pension funds, if pension fund managers had been more focused on *actual* risk instead of perceived risk 10 years ago, gold would have been a much higher percentage of their invested assets, gold would be priced much higher today than it is, and pensioners would be in much better shape.

Conclusion

As Taleb asks, "Why are we so bad at understanding uncertainty? It is now the scientific consensus that our risk-avoidance mechanism is not mediated by the cognitive modules of our brain, but rather by the emotional ones. This may have made us fit for the Pleistocene era. Our risk machinery is designed to run away from tigers; it is not designed for the information-laden modern world."

The human brain is a pattern-seeking machine. It continuously seeks patterns in observations even when there *is no pattern*. In the absence of a pattern, it will make one up. This is a function of evolution and trying to survive in harsh conditions. It seeks things with which it is familiar instead of stepping into the unfamiliar because "better the devil you know than the devil you don't."

Moreover, acting on emotions within the activity of investing can be economically damaging. Yet, too many individuals tie their emotional well-being to their investment portfolio. When they feel euphoric, it's often because they had experienced great returns recently, which can tempt them to increase risk. But typically, euphoria occurs at a point when risk is highest and in advance of large declines. Conversely, when investors feel like they have been kicked in the stomach, it's usually because their portfolios experienced dramatic declines in a short period of time. They might be tempted to try to preserve capital by selling long-term investments to reduce risk, yet their negative emotions often come at a point of low risk and *before* large gains. Keeping emotions in check, or at least not acting on them, is some of the best advice we can give because it will prevent people from doing the wrong thing at the wrong time.

The things that matter in the investing portion of managing one's own finances are: 1) one's asset allocation, or using the more appropriate term – risk allocation. 2) knowing how much capital needs to be withdrawn from the investment portfolio and when, and investing accordingly; and 3) the discipline of the manager in applying a repeatable, thorough investment process and focusing on things that matter – such as hedging inflation risk and preserving purchasing power. It is important to not ascribe too much meaning to events of the past or use them to predict the future. Because of this, investors must have humility and a willingness to be wrong and look bad from time to time because this is an inevitable part of an activity whose outcome depends on an unknown future.

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