The Little Book of Behavioral Investing – Key takeaways

This Is a Book about You: You Are Your Own Worst Enemy

- The investor's chief problem—and even his worst enemy—is likely to be himself.
- Emotion is designed to trump logic.
- Success in investing doesn't correlate with IQ once you're above the level of 100. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.
- As Warren Buffett said, "Investing is simple but not easy." That is to say, it should be simple to understand how investing works effectively: You buy assets for less than their intrinsic value and then sell when they are trading at or above their fair value. However, the gamut of behavioral bias that we display tends to prevent us from doing what we know we should do.
- Investors should learn to follow the seven P's—: Perfect planning and preparation prevent piss poor performance. That is to say, we should do our investment research when we are in a cold, rational state—and when nothing much is happening in the markets—and then pre-commit to following our own analysis and prepared action steps.
- It is particularly important to have a clear definition of what it will take for you to be fully invested.
- Effectively the sources of optimism can be split into those related to nature and those related to nurture.

  Optimism may also endow us with some other benefits. Psychologists have found that optimists seem to cope far better (and survive much longer) when faced with dire news over illness or other problems than pessimists do so optimism may well be a great life strategy.
- Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions. The

purchasers view the current good earnings as equivalent to "earning power" and assume that prosperity is synonymous with safety.

- Skepticism is the chastity of the intellect, and it is shameful to surrender it too soon or to the first comer." These words hold as true in investing as they do in life generally.

The Folly of Forecasting;

- Those who have knowledge don't predict. Those who predict don't have knowledge. Yet, most of the investment industry seems to be obsessed with trying to guess the future.
- The idea of investing without pretending you know the future gives you a very different perspective, and once you reject forecasting for the waste of time that it is, you will free up your time to concentrate on the things that really matter. So, when trying to overcome this behavioral pitfall, remember what Keynes said, "I'd prefer to be approximately right rather than precisely wrong.
- WHEN IT COMES TO INVESTING, WE SEEM TO BE ADDICTED TO INFORMATION. The whole investment industry is obsessed with learning more and more about less and less, until we know absolutely everything about nothing. Rarely, if ever, do we stop to consider how much information we actually need to know in order to make a decision. As Daniel J. Boorstin opined, "The greatest obstacle to discovery is not ignorance—it is the illusion of knowledge.
- We would be far better off analyzing the five things we really need to know about an investment, rather than trying to know absolutely everything about everything concerned with the investment.
- Jean-Marie Eveillard of First Eagle affirms my contention by saying, "It's very common to drown in the details or be attracted to complexity, but what's most important to me is to know what three, four, or five major characteristics of the business really matter. I see my job primarily as asking the right questions and focusing the analysis in order to make a decision."

- Another great investor who knows how to distinguish the signal from the noise is, of course, Warren Buffett. You'll never hear him discuss the earnings outlook over the next quarter or consult an overabundance of information when making an investment. Instead he says "Our method is very simple. We just try to buy businesses with good-to -superb underlying economics run by honest and able people and buy them at sensible prices. That's all I'm trying to do."

- **An Essential focus upon three elements:**

1. Valuation: Is this stock seriously undervalued?

2. Balance sheets: Is this stock going bust?

3. Capital discipline: What is the management doing with the cash I'm giving them?

- Of course, volatility is the very reason why bubble-vision exists. If markets were dull and boring there would be nothing for the commentators to talk about.
- What can we do to protect ourselves against these noise peddlers? One of my former clients had a novel solution. They have just one Bloomberg terminal in their entire office. Anyone approaching the dreaded machine is subject to ritual humiliation. They view the noise as massively counterproductive to their efforts as investors. Turning off the bubble-vision is a great step towards preventing yourself from becoming a slave to the market.
- Researchers have shown that in a series of experiments using urns like in the question above, people tend to under react in unstable environments with precise signals (turning points), but overreact to stable environments with noisy signals (trending markets).
- We tend to hang onto our views too long simply because we spent time and effort in coming up with those views in the first place.
- Hanging onto a view simply because it is your view is likely to end in tears. As Keynes said "When the facts change I change my mind, what do you do sir?"

- Most people who found themselves in this enviable position said the $90 wine tasted nearly twice as good as the $10 wine. The only snag is that the $10 wine and the $90 wine were exactly the same wine! People were simply misled by the price.
- The most-admired companies tend to be those that have done well in the past, in both stock market and financial performance. They also tend to be relatively expensive. For instance, the average sales growth for a company in the most-admired list is 10 percent per year over the last two years. In contrast, the despised stocks seem to have been disasters, with an average sales growth of just 3.5 percent. Thus the admired stocks have great stories and high prices attached to them, whereas the despised stocks have terrible stories and sport low valuations.

  Which would you rather own? Psychologically, we know you will feel attracted to the admired stocks. Yet, the despised stocks are generally a far better investment. They significantly outperform the market as well as the admired stocks.
- The market never failed to overpay for the long-term realized successes of the growth companies, even though the market chose which companies deserved the premium multiples with remarkable accuracy. . . . Nearly half of the price-implied relative growth expectations of the growth and value stocks failed to materialize, so investors were paying twice the fair premium for growth stocks relative to value.

Focus on the Facts:

- Ben Graham insisted that “safety must be based on study and standards, and those valuations be “justified by the facts, e.g., the assets, earnings, dividends, definite prospects, as distinct, let us say, from market quotations established by artificial manipulation or distorted by psychological excesses.” These wise words ring as true today as when Graham wrote them way back in 1934, but very few investors seem capable of heeding them. Focusing on the cold hard facts (soundly based in real numbers) is likely to be our best defense against the siren song of stories.

- VaR (value at risk) tells us how much you can expect to lose with a given probability, such as the maximum daily loss with a 95 percent probability. Such risk management techniques are akin to buying a car with an airbag that is guaranteed to work unless you crash. But as we saw earlier, simply providing a number can make people feel safer—the illusion of safety.
- Never ask a barber if you need a haircut.
- You are asked to count how many times the team in white passed the basketball between themselves. Now half way through this clip a man in a gorilla suit walks on and beats his chest and then walks off. At the end of the clip, you are asked how many passes there were, and the normal range of answers is somewhere between 14 and 17. You are then asked if you saw anything unusual.

  About 60 percent of people fail to spot the gorilla! When the researcher points out the gorilla and re- runs the tape, people always say you switched the clip, and the gorilla wasn't there in the first version. Basically, this study demonstrates that people get too caught up in the detail of trying to count the passes.

  I suspect that something similar happens in finance; investors get caught up in all the details and the noise, and forget to keep an eye on the big picture.
- Sometimes, the potentially long term negative outcomes are so severe that investors simply can't afford to ignore them, even in the short term.

Writing Away Your Mistakes and Biases:

- Extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again, sometimes in a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance.
- When dealing with losses, the urge to reach for an action bias is exceptionally high.

- Perhaps Blaise Pascal put it best when he said “All men’s miseries derive from not being able to sit in a quiet room alone.” Alternatively, as Winnie-the-Pooh pointed out, “Never underestimate the value of doing nothing.”
- A willingness to subjugate one’s own thoughts for those of a group is a sadly common behavioral affliction.

The Dangers of Groupthink:

- Groups have powerful self-reinforcing mechanisms at work. These can lead to group polarization—a tendency for members of the group to end up in a more extreme position than they started in because they have heard the views repeated frequently.
- At the extreme limit of group behavior is groupthink. This occurs when a group makes faulty decisions because group pressures lead to a deterioration of “mental efficiency, reality testing, and moral judgment.”

Alone in a Crowd of Sheep:

- One final word of warning to all budding contrarians—we all like to think we are independent thinkers. Sadly, it is just another one of our failures to actually see our behavior as it really is known as the introspection bias. We see others’ behavior as a demonstration of their underlying nature; while we see our own actions as driven by the circumstances we face (the fundamental attribution error).
- Both of these biases come together to convince us that we are independent thinkers. However, psychologists have explored the foundations of this belief that each of us thinks we act without influence from the crowd, while we see others as being highly influenced by peer behavior.
- It isn’t easy being a contrarian. Make no mistake about it, even the very best investors have to overcome the demon of conformity. Overcoming this particular demon effectively requires three elements.

- Let me emphasize that it does not take genius to be a successful value analyst, what it needs is, first, reasonably good intelligence; second, sound principles of operation; and third, and most important, firmness of character."

Myopia and Loss Aversion:

- The more you check your portfolio the more likely you are to encounter a loss simply because of the volatile nature of stock prices. If only we could avoid the temptation to keep checking our portfolios! Researchers have found that people are willing to invest more when they see the performance of their holdings infrequently.
- Seth Klarman stated that if the technology existed to permit real-time performance measurement of his portfolios, he wouldn't want it, since it would run completely contrary to his long-term focus.
- Yet, investment managers can usually be found scurrying around to achieve superior daily or weekly performance, even though their proper goal ought to be to realize substantial gains farther down the road. This type of behavior makes little sense and can really dent your returns over the long term.

Why You Can't Bring Yourself to Sell:

- This dichotomy between "cigar butts" and "compounders" is an important one for investors to understand. Warren Buffett has described Ben Graham's (his mentor) investment style as cigar -butt investing—that is, buying really cheap stocks almost regardless of the underlying industry economics, and then selling them when they get close to intrinsic value.
- Stocks that Browne describes as compounders will tend to grow their intrinsic value over time, allowing the investor to reap the rewards over a longer time period (assuming that market price doesn't get far ahead of intrinsic value).

- The management of return is impossible, the management of risk is illusory, but process is the one thing we can exert an influence over.
- **Holding people accountable for outcomes tends to increase the following:**
    - Focus on outcomes with a higher certainty, which is known as ambiguity aversion.
    - Collection and use of all information (both useful and useless).
    - Preference for compromise options.
    - Selection of products with average features on all measures over a product with mixed features (i.e. average on four traits, preferred to good on two and bad on two).
    - Degree of loss aversion that people display.
- None of these features is likely to serve investors well. Together they suggest that when every decision is measured on outcomes, investors are likely to avoid uncertainty, chase noise, and herd with the consensus.

Process Accountability:

- If we switch the focus from outcomes to process, things begin to change for the better.
- When there was no limit, an average of 3.3 cans per person was purchased with total sales of 73 cans. When the four-can limit was introduced, buyers purchased an average of 3.5 cans per person, but total sales increased to 106 cans. When the 12-can limit was imposed, the average buyer purchased 7 cans and total sales soared to 188 cans.
- So merely suggesting a number seemed to provoke a very real reaction among consumers. As we mentioned before, this has parallels with much of the modern risk management industry.