ADDING VALUE

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As we discussed in our last newsletter, human nature often conspires against informed, rational decision-making. Succombing to emotional decisions can lead to very serious financial repercussions in the future. The otherwise complex behavior of man is much simplified when he automatically does what he observes around him. It appears from repeated experiments that this "social-proof" tendency is most readily triggered in the presence of puzzlement or stress, and particularly when both exist. It seems as though 2009 had all the characteristics for investors to make the wrong decisions.

BEHAVIORAL TENDENCIES

Robert Shiller, a Yale economist, has some sage advice for investors: "***One key lesson is to acknowledge the complexity of the world and resist the impression that you can easily understand it. People are too quick to accept conventional wisdom, because it sounds basically true and it tends to be reinforced by both their peers and opinion leaders, many of whom have never looked at whether the facts support the received wisdom."***

"Right now I think the wisest strategy is to diversify among your mattresses."

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One recollection during this past year of unprecedented volatility was the great opportunity for "hucksters" to jump on the pulpit and shout their negative opinions. In March, reported financial experts actually appeared several times in one week in back-to-back appearances on both Larry King Live at 9:00 pm and Anderson Cooper 360 at 10:00 pm to hawk the message that people who hadn't yet gotten out of the market were STUPID. Why hadn't they bought books which appeared in prominent displays throughout all the major book store chains explaining how they needed to get out of the market NOW? By our calculations, this message was being broadcast at **exactly** the point of maximum pessimism. Nothing reinforces Dr. Shiller's statement more than these messages delivered during such a fragile financial period and reinforced by opinion leaders. During that time, no one examined if the facts supported the received wisdom. Alternative opinions were never presented.

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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Other great opportunities for hucksters to play games with statistics included story lines such as:

- The idea that started after the market had rallied about 10% from the March 9th low that stock prices were moving up faster than the economy and therefore investors should be cautious;
- The idea that investors, especially seniors, would never re-coup their losses in their remaining lifetimes;
- The calculation that the S&P was down 30% from 2 years ago, down 5% from five years ago, and down 18% from ten years ago where the S&P was calculated without including dividends;
- The perennial headline that equity investing was dead-fixed income is always a better investment. The list goes on. . . .

"If we take a late retirement and an early death, we'll just squeak by."

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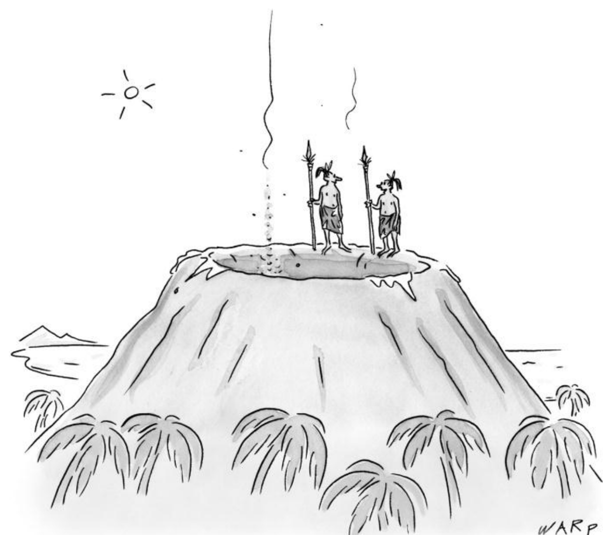
Dr. Ted Klontz, a financial psychologist, says that when it comes to money smarts, size matters: "The logical part of your brain is so much smaller than the emotional side that it's like a circus performer riding an elephant."

<u>To make smart decisions about your finances, you need the logical side to dominate</u>.

To do a service to all of our clients, we must come to work every day prepared to buck conventional wisdom and to tackle complexity with diligent and creative research. We must be prepared to explore the many biases and influences that can derail thoughtful decisions and offer concrete insight on how to avoid them. Human nature often conspires against informed, rational decision-making, a state of affairs that we take VERY seriously. The late Peter Bernstein wrote in his historic review of risk taking <u>Against the Gods</u>: "Games of chance must be distinguished from games in which skill makes a difference. With one group the outcome is determined by fate, with the other, choice comes into play. There are card players and racetrack bettors who are genuine professionals, but no one makes a successful profession out of shooting craps." Like playing poker and betting on horses, investing is a game of skill similarly focused on <u>assessing the odds of uncertain future events</u>. *Investing is inherently a probability exercise*.



"I don't know how the gods feel, but sacrificing financial advisors makes me feel happy."

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Why is it difficult for investors to think in terms of probabilities when assessing a company's future performance and stock price? Our conclusion is that human nature doesn't naturally view the future in terms of a wide range of possibilities and our educational system doesn't augment this failing with training. In addition, we have become accustomed to making decisions by "sound bite". In our busy lives, we simply don't have time to analyze, but instead assume that the aforementioned "opinion leaders" have done so. We more naturally think in terms of what is most likely to occur and implicitly assess the probability of that scenario occurring at 100%. Anchoring on the most likely outcome is a natural attempt to reduce the complexity involved in making investment decisions, but can also reflect the dangerous overconfidence with which many investors (or would-be investors) ply their trade.

Similarly, the explosion in the quantity and availability (if not the quality) of investing-related information is also likely to increase the already pervasive tendency for investment decisions to reflect the "recency bias." We will define this as the human tendency to estimate future probabilities not on the basis of long-term historical experience, but rather on a handful of the latest outcomes. Additionally, as noted in the story line above, some investors take at face value the statement in recent times that fixed income securities win over the long term, because they don't understand the mathematical reality of the end-point bias in the calculation.

In studying the common traits of those most successful at games of skill (across many disciplines), researchers have found a clear tendency of successful practitioners to focus more on process than individual outcomes. Do the right thing enough times and the results in the long term will take care of themselves. That is not to say that process can't be improved. (It always helps to keep a running log of your decisions and truthfully assess whether they were good in the long run.) But more importantly in investments, the single biggest error in most investment processes is the failure to distinguish between knowledge of a company's fundamentals and the expectations implied by the stock price. In other words, the issue is not which horse in the race is the most likely winner, but which horse is offering odds that exceed their actual chance of victory. There is no such thing as "liking" a horse to win a race, only an attractive discrepancy between his chances and his price.

When we come to work every day, this is what we do throughout the day, but especially during times of great volatility. We:

- Turn off Bloomberg, CNN, MSNBC, Fox News. Sound bites are no substitute for research.
- Pull out our records of historical and recent decisions and review explicitly if our past decisions have been good ones.
- Dissect all of our erroneous past decisions and examine how we could have done better.
- Take a long-term view that a retirement portfolio will be spent over one's life expectancy, not all at once.
- Try not to take personally that we simply cannot convince all clients all the time to stay the course.
- Take advantage of one of the most reliable sources of market inefficiency-group think-and try to do the opposite.
- Adhere to a disciplined review process for all investments for positions moving up and down.
- Maintain an adequate margin of safety in all portfolios for absorbing the effect of miscalculations or worse-than-average luck.
- Practice our profession with integrity, professionalism, honesty, intellectual curiosity, and the interests of our clients before our own interests.

Mohamed El-Eman, CEO of PIMCO, recently stated: "It's actually not that hard to have a framework to invest. The framework has three parts. First, you have to have an asset allocation that is forward looking, not backward looking. Second, you have to find the right vehicle to express that asset allocation…and third, you have got to be humble. You've got to realize that managing risk is hard."

2010 is the start of another year. We seem to have come through the 2009 valley of despair with some remaining cuts, scratches and bruises, but seemingly no lasting financial Armageddon. We adapt, we learn, we adjust. Happy New Year!!!

Respectfully yours,

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"Go home, I tell you! The recession is over!"

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