Investing is a Psychology Game Not an IQ Game

Don't Succumb to the Tricks that Ego and Emotion Play on the Rational Side of Your Investor Brain

Source: Carl Richards 2013 'Behavior Gap'

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Introduction

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Key Takeaways

- Ego and emotion are the twin enemies of sound investing.
- The 2008 crisis left us with the biggest investing hangover in modern market history.
- Portfolio managers are scared to death of missing the next correction instead of being hyper-bullish about record highs in the equity markets.

As the old saying goes, human decisions are made with 80 percent emotion and 20 percent logic. After over 20 years in this business, I would say that when it comes to financial decisions, it's 90 percent emotion and only 10 percent logic.

A perfect example is something called the "disposition effect" which I'll discuss in more detail later in this paper. Essentially, the disposition effect describes the all-to-common situation in which portfolio managers hold onto their losers and sell their winners. Having spent 18 years on a trading desk, I can assure you this is the prime reason why portfolio managers underperform--they can pick winners pretty effectively, but they cannot sell their losers. The ego becomes a huge problem around the emotional decision of parting with a name that you spent so much time analyzing. "How can I be so wrong?" you tell yourself. "Eventually my thesis will prove correct."

Wrong!

Why do we think we are so good at financial decision making when the odds are stacked against us? The simple answer can be traced to ego, but ego is the ultimate enemy especially for our investment decisions. Can people in the financial services industry evaluate their own personal financial decisions?

According to **Ryan Holiday**, media strategist and best-selling author of ***Ego Is the Enemy,*** the answer is most often NO.

"One might say that the ability to evaluate one's own ability is the most important skill of all," argues Holiday "Without it, improvement is impossible. And certainly ego makes it difficult every step of the way. It is certainly more pleasurable to focus on our talents and strengths, but where does that get us? Arrogance and self-absorption inhibit growth. So, does fantasy and vision," He adds.

You would think hubris would be high right now due to the market's all-time highs, but again human biases are coming into play.

Longest Investing Hangover in History

The 2008 crisis left us with the biggest investing hangover in modern market history. As a result, portfolio managers are scared to death about missing the next correction instead of the hyper-bullish you usually see around equities when markets are at record highs. As valuations continue to rise above the top quartile, fundamental analysts can't get their arms around being long. The problem is that they are only measuring the "P" in price to earnings--the "E" essentially stands for emotion. Until the money stops flowing into equities, the market will continue to move higher.

The world's most influential living psychologist, Daniel Kahneman, believes that people inside the finance business are terrible at managing their own investments and the flaws around this human decision making is not easily corrected. In theory, we insiders have more information than the average retail investor since we're inside the "sausage factory" every day. But, but in reality more information does not make us better decision-makers. Sometimes it can make us worse.

People who are cognitively busy are more likely to make selfish choices based on intuition instead of based on confidence bias. Let's face it, here is the brain of an analyst or trader processing daily activity in their portfolios, I know during my 18 years on trading desk these narratives filled my brain.

Source: Carl Richards 2013 'Behavior Gap'

Is there any business that keeps workers' brains as cognitively busy as financial services? Investment bankers often work 80 to 100 hours per week. Analysts and traders constantly move from Bloomberg screen, to iPAD, to iPhone between seven meetings and a business dinner almost every day. Hedge fund managers now trade 24 hours per day as electronic trading makes markets omnipresent. The 9:30 to 4:30 trading day of past generations died a hard death only to be replaced by 24/7 technology distractions.

Where Our Biases and Misconceptions Come From

Our psyches are filled with biases and Wall Street employees come from backgrounds in which our predispositions are stouter than the average citizen's. If that sounds like code for "arrogance" to you than you're correct.

READER NOTE: In Appendix 1*, you will find detailed descriptions of Confirmation Bias, Herding, Anchoring, Recency Bias and many other common distortions that our emotions use to cloud our rational decision-making processes. These biases are the foundations of Behavioral Economics, for which University of Chicago professor, Richard Thaler, just won the Nobel Prize.*

For starters, Wall Street recruits from what it believes are the best of the best young minds, coming from the most prestigious schools. Many were scholar-athletes or heads of numerous student groups and organizations. Many more had military backgrounds or other notable leadership experience. These lifetime over-achievers have stellar resumes and type-A personalities, but that's also what causes them to develop massive human biases within their psyches. Most don't realize it.

All these factors lead to "the illusion of skill." The more knowledge we possess, the more that overconfidence bias engulfs us. And that's very dangerous, because a series of human biases are especially damaging to employees in the finance business.

The reason active managers fail to beat their benchmarks over the long-run is due more to psychological reasons than it is to intellectual failures. There is non-stop pressure on portfolio managers to "do something" for outperformance--i.e. trade around positions, add to winners, find out of the mainstream stocks or sell winners…when in fact, doing nothing is sometimes the best answer. When we need to do something constantly, we are making a lot of decisions daily. When we overload our brains with decisions, our human biases come into play.

The illusion of skill is no grim reaper appearing every few years on Wall Street--it's a daily occurrence across finance. Remember Long-Term Capital Management (LTCM) the high-flying hedge fund that imploded in the late 1990s? LTCM and its "absolute trading strategies" was a classic example of the illusion of skill, exacerbated by all the Nobel Prize winning board members and Wall Street titans behind it. However, after a few outstanding years, ego-driven biases crept into the firm's risk management thinking. At least 16 major U.S. banks were lending money hand over fist to LTCM with little knowledge of what the firm was doing with their money or how it was invested.

Then the magic stopped working. In the end, LTCM was facing $1 trillion in default risks as it turned out all of its returns were coming from leverage, known on The Street as picking up pennies in front of bulldozers. After a series of eight-figure paydays for the principals, overconfidence annihilates rationality.

The chief danger among us is overconfidence bias, and those who graduate at the head of their class, with the great SAT scores, and laundry list of hobbies and activities are among the most susceptible. They arrive on Wall Street at peak testosterone—yes it tends to be a male trait--ready to take on the world. They're so confident that now is their time. This overconfidence leads to way too much faith in intuition. However, the trader's "gut feel" or the analyst's "hunch" is what can lead to serious personal portfolio damage. This hubris allows us to exaggerate our ability to forecast the future. The key to our belief system is reading the tea leaves about what is about to happen. Unfortunately, mountains of evidence-based academic research tell us that no one is really good at predicting the future—at least on a consistent basis.

The LTCM saga illustrated many more biases that are especially prevalent among investing professionals, including the "**halo effect**" and **narrative fallacies**. The halo effect essentially describes a person whom we believe can do no wrong, at least for the time being. the global impact of a likeable personality, or some specific desirable trait, in creating biased judgments of the target person on any dimension. Thus, feelings generally overcome cognitions when we appraise others. Hero worship on Wall Street is almost as common is it is for celebrities and star athletes in mainstream society. Following the hot analyst or hot fund manager blindly happens all the time within financial circles—far more often than it does among average retail investors.

According to Kahneman, those with the most knowledge are often the ones who are less reliable. "The reason is that the person who acquires more knowledge develops an enhanced illusion of her skill and becomes unrealistically overconfident," explains Kahneman. This gets to the core of investing--**it is a psychology game, not an IQ game**. Just because you did the work doesn't mean you will make the right decision under sensitive circumstances.

According to an investment theory called "**Davis's Law,**" the degree of unprofitable anxiety in an investor's life corresponds directly to the amount of time one spends dwelling on how an investment should act rather than the way it is actually acting.

As I've learned over several decade in this business, investing successfully belongs to the humble--being aware of how much we don't know and can't know. This is a game of inches and sometimes centimeters, or as Warrant Buffet's long-time partner, Charlie Munger, likes to say, it's best to avoid stupidity rather than to seek brilliance.

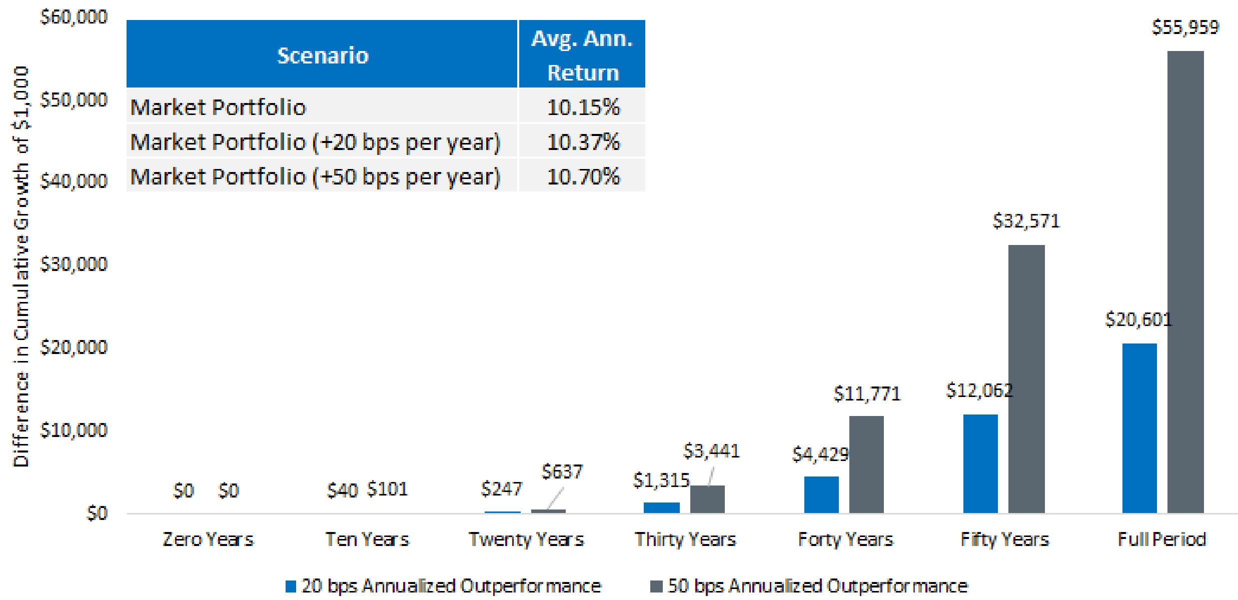
As financial professionals, we are guilty of confusing opinions with facts. That's pretty absurd considering there are no hard facts about future events. A preference for complexity, matched with false confidence that we can predict the future, too often causes us to embrace stupidity rather than avoiding it.

By contrast, a simple strategy, such as the one we use, forces us to embrace effortlessness, thus avoiding short-term noise and owning our decisions. This unpretentious approach to portfolio management recognizes that the markets really work. So, let's focus on the things we can control like fees, taxes and rebalancing, and avoid wasting time on chasing the next hot stock, trend, sector or manager. After those factors are under control, we turn towards evidence-based investing for asset allocation, focusing on a systematic approach that removes human emotion.

The best ways for active managers to provide value to clients is by having concentrated positions and exhibiting active share. In order to add alpha over an unmanaged index, you have to differentiate yourself in a big way by making concentrated bets in certain sectors or stocks. The more you look like an index, the less reason there is for people to pay you a higher fee. The second way to add value for clients is to stick to a process. Active managers that outperform over the long-run, tend to suck sometimes over the short-run. They must avoid straying from their model just to massage short-term results for clients.

How Active Managers Use Mental Discipline to Add Value

Basis Points Matter-Wisdom Tree



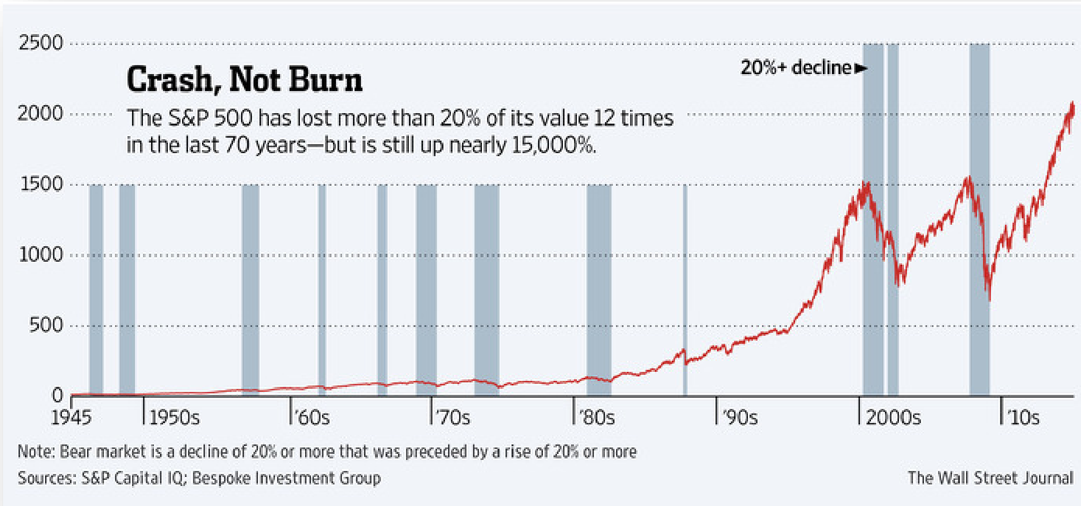
Sources: WisdomTree, Kenneth French Data Library. Period is from 6/30/1963 to 3/31/17. Performance is hypothetical.

In a 24-hour news cycle, it NEVER sounds like a good time to buy equities. Considering all the dark clouds hovering overhead--Trump, North Korea, China Debt, Iran, floods, earthquakes, wildfires and hurricanes--what rational person would ever invest in this environment? "The end is near!" we are told again and again.

Q5-Fear never really leaves the psyche of investors. If anything it's been at a permanent hyper level post-2008. As I mentioned earlier this has led to the greatest investment hangover in modern times. There is still more money flowing into bonds than there is into stocks. There is still tons of cash on the sidelines and still we lack the euphoria that ends bull markets.

Human beings inevitably overestimate the possibility of unlikely events. This leads to investors paying big premiums to avoid the small risk of a large loss. This strategy this can be quite costly whether it stems from using derivatives or simply sitting on too much cash. Fear is the primary cause of investment failure. Markets do not cause permanent loss--people do--when they make emotional decisions. Your risk of missing a 100-percent uptick in the market is much higher than suffering a 25-percent downtick. If you don't believe me, see the chart below. In the last 70 years, the S&P 500 index has recorded 12 corrections of at least 20-percent. But even with those setbacks, the market is up over 15,000 percent during that time.

Bear Markets Are Giant Sales



Since World War II, the U.S. has recorded 13 recessions, lasting on average 10 to 11 months, with the longest being 19 months in 2008-2009. The problem is not related to market returns; the problem is that the fire on the right side of your brain creates permanent losses through poorly timed emotional decisions. The markets provide wonderful returns, but smart people have a massive preference for complexity.

There is an inherent belief that a complicated investment landscape requires a complicated solution. In reality, simplicity is what encourages an investor to own their decisions and to avoid over-reacting to short term volatility. Unfortunately complexity is what sells in our society. Smart people want to hang out with other smart people, especially when it comes to making money. But the REALLY smart people are the ones who hang out with people who know how to avoid stupidity.

As always, thanks for trusting me with your money and please call anytime for questions or further discussion. (610) 313-0910

Don't forget to skim Appendix-1 for more information about the most common tricks that egos play on rational investors' brains.

Best Regards,

Matthew Topley
Chief Investment Officer

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VIEW FROM THE TOP

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======================= APPENDIX-1=========================

Behavioral Economics Primer

Tricks that emotions play on the rational side of the investor's brain

Recency bias

We tend to make our decisions—especially financial ones—based on what happened to us most recently. Suppose we had a tech stock that zoomed up by 50 percent just a week after we sold it. Then suppose we have an earnings miss on another tech stock we're holding, even though our disciplines might tell us to sell it. We're scared to death that the same timing mistake we just made will happen again – i.e. it the stock will zoom back up right after we sell it.

We have the longest recency bias ever occurring right now. It's really the longest investment hangover ever. Many people are still very fearful about what happened in 2008-2009. No one in our generation was ever shocked like we were in 2008-2009 and that's been implanted in people's minds. When I talk to retail investors, the only thing they want to ask me about is "when is the market going to crash?"

Crashes like we had in 1929, 1987 and 2008 are very rare in market history. Recessions and pullbacks are much more common. But, everyone I talk to is thinking about the next market crash, rather than investing in this bull market.

Anchoring

In one sense it's about having a mental stake in the ground to give you a framework for making decisions. For instance, the Shiller CAPE ratio is above 30 so I'm going to sell or if Buffet's Market Cap-to-GDP Indicator is above a certain number, I'm going to sell. Sure, the market is more expensive today than it has been historically, but those aforementioned ratios don't tell you when to buy and they don't tell you when to sell. So we can anchor into these numbers—for example news about new market highs is blaring every day. And people are saying to themselves: "New highs! New highs! It must be time to sell." But think about it. New highs are usually a positive sign for the market. We get anchored into these numbers and they screw up our thought process.

People have personal anchors as well. It could be something that happened to them in their childhood. It could be something that happened in their career. They get these negative personal anchors that they can't overcome. We all have past psychological issues or family issues that are affecting our everyday decision-making process. And those issues get anchored into our decision-making.

As a general rule, introverted people tend to be more skeptical. And that mindset can really hurt us in our investing because you miss out on opportunities or give up on an investment too quickly. On the flip side, extroverted people tend to be optimistic most of the time, but that can also hurt you as an investor, because you're exposing yourself to too much risk.

We have personal anchors and professional anchors. The personal anchors are psychosomatic things going on in our lives that affect our daily work decisions. Professional anchors are the numbers and ratios I just talked about that keep getting stuck in our head. By the way, we've talked about not being influenced by the financial media, but what kinds of people tend to go into journalism—introverts who are skeptical by nature. So keep that filter in mind, whenever you read, listen or download the latest from your favorite news source.

Mental accounting/fallacy of breakeven

Mental accounting is a classic individual thought process and it's a classic portfolio manager process. My favorite example is "getting back to breakeven." Picking winners is not the big problem for most portfolio managers; the big problem is that they can't let go of losers. When you're holding on to your losers, your ego gets in the way. You tell yourself: "I'm right about this stock, it's just the market is not recognizing its value yet." Or, you tell yourself, "I did so much work analyzing this stock, I know I'm right about it." So you start doing all kinds of mental accounting and then at the end you tell yourself that you'll sell the stock just as soon as it gets back to breakeven. And that's an ABSOLUTE KILLER in investing. Holding on to losers for too long is the WORST thing you can possibly do. And, a lot of holding on to losers is doing a lot of mental accounting and waiting to get back to breakeven.

Think of it as playing with the house's money (paper profits????]. Mental accounting is a very dangerous animal in your personal life, in your personal finances and in investing. When you hold on to a losing investment for too long trying to get back to break even—it could be a stock, bond or real estate—there's an opportunity cost. All those months and years that your money is tied up waiting to get back to breakeven means it can't be deployed elsewhere in a more profitable investment.

Herd behavior

Herding is my all-time favorite. The herding mentality and reversion to the mean are two of the biggest thought breakdowns we see again and again. They never seem to go away. One of the biggest reasons this near-record bull market keeps running is that we have not yet seen the euphoria that we typically see at the top of the market. We don't see herds of retail and institutional investors herding in U.S. equities and nothing else. There is still more money flowing into bonds than into stocks. There is still A LOT of cash sitting on the sidelines.

If you look at the history of markets, the herding mentality never fails. Everybody herded into tech stocks in 1999……60 percent of money every month was flowing into NASDAQ stocks. Small-cap value managers were going out of business all over the country. The herding mentality repeated itself in classic fashion during the housing boom of last decade, where we had "No-documentation" loans…..And people making $50,000 a year, borrowing all the equity out of their house to buy up rental properties. The herding mentality is classic behavioral finance. On the momentum side, it's also

Take price-to-earnings (P/E ratio). The fundamental side is the "E" (earnings) ….getting the earnings right based on fundamentals. But, that only tells half of the story. The "P" is the price and that's where you get into the psychology. You can be completely right about the fundamentals of the company and completely wrong about what that stock ends up doing based on the fundamentals. That's the herding mentality. Just because a stock is trading at 40 times earnings, does not mean the stock is going down. Right now Vanguard is buying $2 billion a day of the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) just because everybody is piling into indexing. Well guess what? The FAANG stocks are super-expensive, but they are NOT going to go down until Vanguard stops buying $2 billion a day of them. This is a classic example of the herding mentality in real time.

Money is piling into index funds. Vanguard has to buy them every day. As long as there are more buyers than sellers, those stocks will continue to go higher, no matter how expensive they are.

Confirmation bias

This is classic portfolio manager/trader behavior. You have a thesis, but you want it confirmed by other so-called experts. You run out to Wall Street analysts and you run out to your peers to get their blessing that your thesis is in fact a good idea. So, you run around trying to get confirmation bias from all your friends and as we know all too well, that usually doesn't work when it comes to investing.

Usually the person who has the stinky idea that nobody likes, is the one who succeeds. As investing legend Warren Buffet likes to say, "Invest when there's blood in the streets." Invest when other people are running away.

Confirmation bias illustrates the danger of following the news media all day long and the danger of blindly following someone who has the "halo effect" (aka hot hand for the past several years). So you dive in and start following them and it doesn't work out.

Confirmation bias is rampant on Wall Street. If you look at everyone who made a fortune on Wall Street during the 2008 market crash…most of them have done really poorly since then. Nobody ever heard of them prior to 2008. They got the crash right. They achieved the "halo effect." Everyone piled into their funds and they've done very poorly every year since then.

Gambler's fallacy

This occurs when you believe a purely random event is really NOT really random and that it's going to continue to happen into the future. You start loading up on FAANG stocks now because you think they're going to stay hot forever. You predict the next coin flip is going to land heads because the last 20 flips also landed heads. In reality you have no way of knowing which side is going to land facing up. It's completely random, just like so much of investing. Most of the time, we have no control over what's going to happen in the market. This fallacy that you actually have control due to some event that is random that you think is NOT random.

Hindsight bias

Hindsight is another classic investor bias. It's like the guy who tells you on the golf course or at your kid's soccer game that he knew 2008 was going to happen. He is the same one who told you he knew the 1999 bubble was going to burst. Everybody has their own belief system--they knew something was going to occur, but they didn't act on it or they knew it, but they didn't have time to act on it. Again, it's an example of how our ego gets in the way of our clear decision-making process. It's this whole notion of "I knew it all along" effect. I like to call this phenomenon, "creeping determinism."

We have this belief based on things that happened in the past and that twists our perception of current events. That's because we're telling ourselves a mental lie that we knew the stock market was going to crash in 2008--we tell ourselves knew it all along. Now we're looking at the current market and we're telling ourselves this lie which is giving ourselves a bigger and bigger ego.

Daniel Kahneman was the classic student of hindsight bias—of our egos getting in the way. Like I always say, investing is a psychology game; it's not an IQ game.