Chapter One

The Nut Behind the Wheel

Behavioral Finance in One Lesson

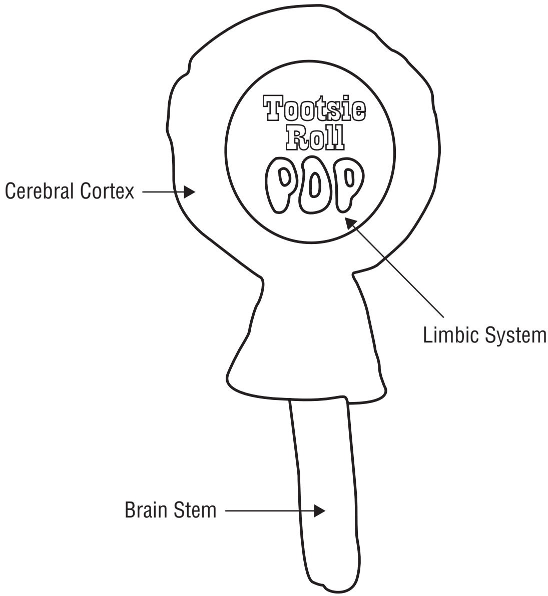
As Ben's sister, Rachel, likes to say, "Your basic human is not such a hot item." Nowhere is this truer than when it comes time for said average human being to manage his or her own investments. To understand what has gone so very wrong with our financial lives, we need to look more closely at the man or woman in the mirror.

Two devils toss investors back and forth between their pitchforks. One of these is *Greed*, and the other is *Fear*. According to this model of investor psychology, the prudent investor is the one who chooses a moderate course, being neither inordinately greedy nor disproportionately fearful. This investor reins in his feelings and threads an Aristotelian mean between these two emotional extremes. There is a lot to be said for this line of thinking, probably because it is true.

If we probe a little deeper, we see that greed and fear are not two emotions, but one, and that single emotion is . . . fear. In fact, greed is not an emotion at all, but rather a moral state (one of the Seven Deadly Sins). Greed springs from fear. We fear that we will not have enough, and so greed overcompensates. At its most primitive level, greed is the fear that the big breast of life will be snatched away, leaving us forever unfilled. Greed can mask social fears as well. We fear not doing as well as our brother-in-law or our next-door neighbor. We may fear that our families will be disappointed with us as providers—that we won't be able to afford that good school, that fancy wedding, that house with the swimming pool.

Why are we so fearful? As Figure 1.1 shows, the brain is like a Tootsie-Roll Pop. The brain stem is the white stick. It is surrounded by a chewy chocolate center, the limbic system, where fear and rage and emotions lurk like a bag of snakes. Finally, it is covered by the cortex, the hard candy shell where thinking occurs. Most of our decisions are emotional

Figure 1.1 The Human Brain



at base, and the cortex just makes up reasons to justify them after the fact. This primitive brain wanders through our modern world of fax machines and skyscrapers ever on the lookout for flesh-tearing saurians.

Homo sapiens is a frail, vulnerable creature. Because our thinking and emotions are so enmeshed, it is no surprise that our investing has become confused. So, let's all come up to the front of the tent right now and confess: Investing is terrifying. It is very scary to put our life savings on the line. If the smartest people in the world can manage to screw it up, what chance do we have to come out with our skins still attached? These thoughts lead us into a desperate search for confidence and reassurance where our investing is concerned. This search takes myriad forms. We'll highlight two of them.

The Unwisdom of Crowds

One of the main ways we seek to allay our fears when we invest is to seek safety in numbers. If everyone else is doing it, at least we won't be out on a limb by ourselves. Unfortunately, this strategy doesn't work. Everyone piles into the market when the market is highest, and dives for the exits when the market is lowest. Following the crowd means following a "buy high, sell low" philosophy that produces the worst results of all.

Crowds have their own distinct patterns of behavior that are inimical to investors.

First, crowds engage in *groupthink*—the tendency for everyone in a group to think alike. Mobs move to a consensus and then squash dissent. Anyone who questions the consensus view is held out for social ridicule.

Second, crowds display something called *response polarization*. This means that nuanced responses get washed out in favor of starkly black-or-white, simplistic choices. A stock or an investing idea is viewed as being either all good or all bad.

Third, crowds show a *risky shift*. This is the "lynch mob" effect. Taken singly, people are unlikely to storm the Sheriff's office to string up Black Bart. Once in a group, however, they feel invincible. Groups are likely to adapt more extreme positions than individual members would take individually.

All these tendencies undercut the wisdom of crowds.

There are famous examples where individuals guess the weight of a pig or the number of jellybeans in a jar, and the group estimates turn out to be astonishingly accurate. This is the basis for *efficient market theory*, which contends that all actors in aggregate have a better fix on the price of, say, Microsoft, than any individual participant is likely to have. However, in the case of the jellybeans, the estimates were made singly, with no consultation among participants. In the case of stock prices, the guesses of all other actors are known, and their value, direction, and momentum serve as anchors for each next guess. This amplifies price swings far in excess of what is justified by stock fundamentals, and accounts for the manic-depressive moods of the stock market (or "Mr. Market," as the investing genius Benjamin Graham personified it). Think of how much better it feels to buy a stock on an "up" day when everyone on TV is smiling and happy than on a big "down" day when the anchors are somber and grim. Yet, you do far better when buying low.

Bottom line: Do not trust the Force when investing. John Bogle, founder of Vanguard Group and patron saint of investors, was able to estimate the cost of investing according to our feelings. He found that, from 1980 to 2005, buying high and selling low cost investors 2.7 percent annually over a simple buy-and-hold strategy. Our emotions are at best a contrary indicator, leading us to do the opposite of what we should. That is investing psychology in one sentence.

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Our Portfolios, Ourselves

A second way we search for security in securities is by buying stocks that are cool, like our cars and our clothes. We are, after all, what we own.

In 2000, people bought CMGI for $137 a share (adjusted for splits). Today it sells for $1.59, for a loss of 99 percent of your original investment. That same year, you could have bought Sycamore Networks (SCMR) for $171; now it's at $3.79, for a loss of 98 percent. If you loved Palm (PALM) at $1,084, you must be thrilled to be able to buy more today for $26.57 (a loss of 98 percent). People who thought i2 Technologies (ITWO) was going to the moon at $2,600 a share can find more today for $18, for a loss of 99 percent of their initial investment.

CMGI, you will recall, was the famous incubator of Internet companies that was going to rule e-commerce (and in the World of Tomorrow, was there really going to be any other kind?). Sycamore Networks provided seamless optical integration of e-business networks and processes to optimize their data infrastructure. Palm makes the ubiquitous digital assistants that are nothing if not an extension of our nervous systems. i2 Technologies is a software company that revolutionizes supply chain management.

Free association time: What adjectives come to mind when we think of these companies from the standpoint of 1999? Hot? Sexy? Fast? High energy? New? Smart? Futuristic? Feel free to make your own list.

Now consider some different companies: Hormel, they make Spam; Altria, purveyors of death in the form of tobacco; Arch Coal, they make coal. How do these companies rank on the same continuum we just constructed? Perhaps such words as "*bor-ring*," "yesterday's news," and "just say no" come to mind. If you were going to a cocktail party in January 2000, would you rather be able to say you worked for i2 Technologies or Arch Coal? One business card would lead to waking up the next morning in a suite at the Plaza with an empty bottle of Dom Perignon on one side and a blonde on the other, while the guy with the other card ends up at home by nine watching a *Love Boat* rerun with a bag of Cheetos.

However, if you'd bought any of these boring companies that month, you would be far richer as of 2009: Hormel is up 110 percent, Altria is up 366 percent, and Arch Coal is up 738 percent. Today, it's the guy from Arch Coal who gets the girl (she knows he can keep her warm).

We buy stocks that are a reflection of our ego ideal.

The problem is that everyone else is doing the same thing. This means we are paying a big premium to invest in companies like these. When we buy groovy companies, we are not paying for a hamburger today but for a hamburger next Tuesday. We can see it, we can taste it, but it's not exactly in the bun yet. We know how Spam is selling already—there's very little mystery left—but the sky's the limit when it comes to thinking how big that company in China is going to get. It can be as big as your imagination.

What happens next? It turns out that we have overpaid for our sexy growth stocks. The earnings don't materialize as we dreamed they would (and paid a price to match). On the other hand, we weren't expecting much from Altria or Hormel to begin with, so we didn't overpay for them. This is why the Brandes Institute found that stodgy large-cap U.S. value stocks (more about these later) outperformed large-cap "glamour" stocks by 6.8 percent annually from 1968 to 2008. Our investing narcissism has a price.

This brings us to our little list of Investment Psychology Do's and Don'ts.

Investment Psychology Do's and Don'ts

Here are some better ideas than investing to be hip, slick, and cool.

DO aim low.

As in any 12-step program, the first step is to realize that we are powerless over the market. However smart we are, we cannot control how our investments will perform, no matter how much we study and prepare. There are always larger forces at work.

This means we should aim low. The lower our aspirations, the more likely it is that we will achieve them. It is seldom a good idea to make any "bold" investment decisions. The market exists to teach us bone-crunching lessons in humility. You can lose real money there. Investments that will give you big returns without commensurate big risks are like Elvis sightings: intriguing, perhaps, but seldom verified.

DO be patient.

Our time horizon is the rest of our lives, not next week or next quarter. Our goal should be to harvest the long-term positive returns flowing from global capitalism—a proven and profitable economic system.

The market pays us to assume stress. If we wanted to eliminate stress, we would earn the returns of T-bills. Of course, this would lead to its own form of stress later on, when the time comes to retire, because our nest egg would not grow enough to support us later in life. We need to take on more stress from our investments today so we can have less financial stress in our lives later.

DON'T panic or be elated over short-term market events.

There is no advantage to being a "hot reactor" and working ourselves into a lather over breaking news and market events. Feelings come and feelings go, and feelings are not facts. Our tendency is to take today's headlines and rush down the field with them to some horrible or wonderful goalpost. Selling in a panic can destroy a lifetime of investing returns. The news can be grim day after day and the world is coming to an end, and then suddenly, when no one expects it, the news is good and the robins are singing and what was all the fuss about, anyway?

Investors overreact to good and bad times alike, and over-extrapolate from short-term trends into the future. We have a poster from Dimensional Fund Advisors—one of the top investment advisory firms that has ever been—showing a timeline for the past 100 years with news headlines pasted over it. These events include: "World War I," "Communist Revolution," "Influenza Pandemic," "Stock Market Crash of '29," "Great Depression," "Pearl Harbor," "Sputnik Launched," "JFK Assassinated," "Arab Oil Embargo," "Disco," "Stock Market Crash of '87," "Gulf War," "September 11th," and so on. Over this is a corresponding chart of the stock market, which climbs at about a 45-degree angle throughout the century in seeming disregard of all the disasters that befell us. From the point of view of a long-term investor (and all of us are lifelong investors, now), these crises proved to be terrible times to sell stocks. If you think that because you despair about the state of the civilization (your authors' chronic condition) it follows that you ought to liquidate your portfolio, think again.

Next up: A look at what is Ground Zero in many ways.

Do's and Don'ts

- Don't trust the Force when investing. Your emotions are contra-indicators of what you should do.
- Don't invest in companies because you think they are sexy and cool or because you want to be cool.
- Do approach the market with great humility and realize that you are powerless over the market.
- Do be patient. The market pays you to assume stress.
- Don't get hopped up over short-term market events, despite the media's attempt to whip you into a frenzy.