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• One Man's Opinions – Spring 2012

ONE MAN'S OPINIONS –Spring 2012 **More Lessons I Have Learned**

In my 2004 Fall quarterly newsletter, "One Man's Opinions," I discussed in detail an interview in the June 2004 Financial Advisor magazine with Dr. Daniel Kahneman, a tenured psychology professor who had won a Nobel Prize in *Economics* for his work in the field of behavioral psychology. In the interview he affirmed many of my beliefs regarding investing and investors during the prior 42 years. I shared them with my readers at that time. You might wish to read the newsletter on tommcallister.com. I evolved a lecture from that newsletter, "Lessons I Have learned," which has proven very popular with my audiences on several dozen cruises

Dr. Kahneman has continued his work, as I have. Now I would like to discuss more recent lessons I have learned during my now fifty years in this highly fascinating and rewarding profession. Early in his career Dr. K coined a term "the illusion of validity" and has since expanded it to "a tendency for people to view their own beliefs as validity." In the past two years or so we have had an excellent example of this as the media and the public continued to believe the United States was still in an economic recession. This is in spite of evidence that the recession bottomed out and the economy began to recover (albeit very weakly) in June of 2009. Only in recent weeks, after almost three years since the bottom, has the public and the media began to see and believe the facts.

In our defense, according to Dr. Kahneman, we humans have neither the temporal flexibility nor the neurological capacity to analyze all the data available to us in this day and age. This has been compounded by the internet, which has multiplied the already staggering amount of data available to the average literate human many times. We humans therefore, develop subconscious strategies as a problem solving aids; "short cuts," which the psychologists call heuristics. These are time-saving, energy-saving rules of thumb which allow us to simplify the decision making process.

Normally this is not a bad way to go. Heuristics is a solution to our problem of ever limited mental resources. Even the brightest of us have this limitation. But Dr. Kahneman has discovered that there are certain situations, and I notice there are many of them in the investing process, where our reliance on heuristics leads to "severe and systemic errors." These errors have been come to be known as "cognitive biases." An example of this, common in my work, is "confirmation bias," a tendency to search for and/or interpret information in such a way as to confirm our preconceptions. It is epidemic in Wall Street.

This bias is just one of a litany of them that I notice in investors. Especially in the financial media I see constant "negativity bias," which is the tendency to give more weight to negative information and experiences than positive ones. This bias is easy to understand, bad news attracts more readers, listeners, and viewers than does good news. All the media tend to do this, not just the financial ones.

Then there is anchoring bias, the predilection to rely on one piece of information when making decisions. For example, we in the lower United States have had an extraordinarily warm winter this year. From this information one might conclude global warming is absolute and growing. This conclusion totally ignores the record cold winter experienced in Europe, Alaska, and other parts of the world.

Another bias in we humans is the “bandwagon effect,” the tendency to do or believe things because others do. We see this all the time in the stock markets. People see others “getting rich” so they rush in and buy very late in a market rally in an attempt to “get rich” also. All too often the result is a loss, after which they sell their positions, condemning “the market” and all involved. Most in this business are trying to help our clients meet their financial goals over the long run. It is good business to do so.

These, and other, biases tend to be experienced in pairs or trios. This makes it quite difficult for the average public investor to succeed on their own, given the enormous knowledge being generated for their consideration, and the volatile markets common today.

Also, in recent years, psychologists have begun to notice larger patterns in our biases. In hundreds of studies researchers have consistently found that we overestimate our own attractiveness, intelligence, work ethic, impact on external events and other people, as well as our chance for success, and chance of avoiding a negative outcome, and even the superiority of our own peer group. But there is a flip side: where we stubbornly overestimate ourselves, we also significantly underestimate the world at large!

We all too often tend to be control freaks, and are significantly more optimistic about things we think we can control. Stock and bond markets, by the way, are not controllable by anyone. By the same token, we tend to throw up our hands and quit in anger if we perceive we have no control over something, be it the stock market, bond market, oil and gasoline prices, or the unemployment rate.

Compounding all the above conditions and the source of most of our financial mistakes, is a very basic part of our brains called the amygdale (ah-mig-dah-lah) which is an almond shaped sliver of our temporal lobes at the lower back of the brain. It is responsible for our primal emotions like rage, hate, and fear. All primates possess such brain parts, even lizards. It is our early warning system, an organ that is always on high alert, whose job it is to constantly monitor our environment to find anything which might threaten our very survival.

Anxious under normal conditions, once stimulated the amygdala becomes hyper vigilant. Our focus tightens and our fight or flight response turns on. Our heart rate speeds up, nerves fire faster, eyes dilate for improved vision, the skin cools as blood moves to our muscles for faster reaction times. While all this is going on, cognitively our pattern recognition system scours our memories, hunting for similar situations to help identify the threat, and for potential solutions to help neutralize the threat. But so potent is this response that once turned on, it’s almost impossible to shut off. This is a huge problem in our modern world with its massive amount of stimuli!

Our days are saturated by information. This is in contrast to our ancestors, who hunted or gathered, and lived in small groups for mutual help and defense from outside threats, and whose world was pretty much limited to how far they could walk in one day. Today, on the other hand, we have literally millions of information sources from all over the world competing for mind share. How do they compete? By appealing to the amygdala, which is already primed to look for danger. It can almost always find something to be alarmed about in the world we live in today! The media, consciously or not, feeds our amygdala with 90% pessimistic news! Quite simply, good news does not immediately catch our attention. Rather bad news does because our amygdale is always looking for something to fear!

This has an immediate impact on our perception. Even under mundane circumstances, attention is a limited resource for us humans. Any fear responses only amplify our emotional reactions. What this means is that our amygdala is always hunting for bad news and it mostly is going to find bad news.

Compounding this tendency, our early warning system evolved in an era of immediacy, when threats were of the “tiger in the bush” variety. In contrast, most of today’s dangers are probabilistic, the economy might nose dive; the Iranians might develop a nuclear capability, the Israelis may move to eliminate the threat; the Taliban may take over Afghanistan; or Italy may renege on its debts. The amygdala cannot tell the difference! And worse yet, it is designed not to shut off until the potential danger has completely vanished. But probabilistic dangers never vanish completely! Add in a constant barrage of media bad news and you have a brain convinced it is living in a state of siege. This is why my readers often find me “ranting” about the financial media and its emphasis on short term bad news, both real and probable.

I first learned of the amygdala and it's impact on our emotions last year when studying Imago, a relationship therapy which takes into consideration the effects generated by it on relationships. I found it fascinating. Now Dr. Kahneman has brought it home to me in my work, suggesting how these powerful emotions tend to trigger irrational or even plain stupid actions by us humans. For example, I recall a client, a dairy farmer with a large herd, who at very bottom of the stock market decline of 2002 closed his million dollar account with me. He said he believed the stock market, down some 25-30% at the time, was going to zero. I asked him if he thought there was a chance all 600 of his producing cows might die suddenly (They had daily veterinary supervision as to their environment and diets). His response was, "they might!" That ended our conversation. If he feared that about his business, in which he had spent his life, then it was fruitless for me to expect him to trust my judgment about the stock markets. Less than four months later his account would have been up 25% had he stayed the course.

That same month another client, an unsophisticated lottery winner, left because his account was down $50,000, more than he made at his job. This represented 1% of his $5 million account, 80% of which was in tax free municipal bonds. Again, I had misjudged his risk tolerance. But I would have been derelict in my fiduciary obligation to a man in his late 30s if I ignored inflation and put him 100% in bonds. (The long term goal was to have him 50/50 in stocks and bonds.) These two incidents in my career, happening in the same month, taught me a lesson about my client's risk tolerance. I probe a lot deeper since then. Let us look at the lessons I listed seven years ago with our amygdala in mind.

People are not rational about their financial decisions. To one degree or another most make decisions from their emotions. In this case we are allowing our fears, almost always overrated, to control our actions. Many investors sell when prices have fallen to bargain levels, often after those same emotions have caused us to buy when prices were at all time highs. Almost all professional money managers have learned to override their emotions, to make decisions rationally. If not, we fail and drop out.

Here are updated summaries of the lessons I first discussed back in 2004 for your consideration.

Most investors "narrow cast." They do not look at the big picture and their individual circumstances within that picture. They jump in on a "tip" and bail out when things get volatile.

Mistakes are inevitable in investing. They cannot be avoided, but one can plan for them. This means overriding our amygdala.

Ignorance of what is and what is NOT an investment opportunity. The investor is overrating his or her own ability to find such opportunities. For example, people like to buy stocks they are familiar with, local, their own industry etc. etc. This can be good or bad.

Most investors do not know the difference between "risk" and volatility. Our amygdala is afraid of volatility, we cannot control it.

Some watch their holdings too closely. This engages our amygdala as our fears intervene.

Some do not pay close enough attention, they do not "weed the garden" periodically. In these cases they have may have "turned off" or "tuned out" obvious warning signs

For most investors the best advice is to; "Hire a Professional Investment Advisor." There is NO substitute for decades of successful experience as an investment advisor. I and my managers would welcome an opportunity to discuss your personal situation.

Tom McAllister, CFP

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