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THE LITTLE BOOK of BEHAVIORAL INVESTING

How Not to Be Your Own Worst Enemy

JAMES MONTIER

Foreword by JOHN MAULDIN, Bestselling Author of *Bull's Eye Investing*

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How Not to Be Your Own Worst Enemy

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To Charlotte
Your smile lights up my world

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Foreword

Homo Mistakus

I AM RATHER AN EXPERT ON BAD CHOICES. I have made so many over the years, from unhealthy food choices to postponing exercise (today's bad choice) and yes, even regrettable investment choices (sigh).

And then I have observed so many bad choices on the part of my seven teenagers. (Thankfully, now down to just one, but these days I get to watch my grandkids learn to navigate the world.) Teenagers have a remarkable ability to make the easy choice today and postpone the hard and difficult choice until tomorrow. And some of us grow up, having perfected that ability, making even more bad choices as adults.

I have interviewed hundreds of investors over the years, from small and starting out to having-arrived billionaires. I am always amazed by the mistakes they make and the inventive rational they use for having made them.

As a nation and a world, we have made numerous bad choices, taken the easy road, and ended up in the worst global economic crisis in 80 years. Now we are faced with a set of difficult choices as we work our way back to a new normal. History is replete with bad choices by both individuals and nations.

In the past few decades, a new science has emerged that has taken note of the fact that not only are we sometimes irrational, but we are predictably irrational. This new behavioral science has started looking at how we go about making decisions and is finding all sorts of interesting, if sometimes distressing, things about the human species.

It seems that our emotions and much of our decision-making process is hard wired into our brains, developed for survival on the African savannahs some 100,000 years ago. We adapted to movement, learning to make decisions quickly, because there was quite a difference, literally life and death, between dodging dangerous lions and chasing succulent antelope.

And while those survival instincts are quite useful in general, when translated into a modern world, and

especially a modern investment world, they make us prone to all sorts of errors. Think of chasing momentum all too often in the hope that it will continue and running from falling markets just as they start to turn. What works for survival in the African jungles is not as productive in the jungles of world finance.

Happily, we are not just *homo mistakus*. If we had learned to make nothing but bad choices our species would have been consigned to the dust bin of history a long time ago, making room for some survivors less prone to error.

We clearly learned to make good choices as well, and to learn from our mistakes and even the success and wisdom of others. As I mentioned earlier, I have formally interviewed hundreds of millionaires. I am even more fascinated by choices they made that were the good (and sometimes brilliant!) ones, and the processes they used to make them.

As a human species, there is much to be admired about *homo sapiens*. We are capable of great work, soaring ideas, and wonderful compassion, all the results of good choices. And behavioral science is helping us to understand how we make those choices.

Even as what was once considered the foundations of finance (the efficient market hypothesis, CAPM, and modern portfolio theory) are being questioned and even blamed for much of the problems in the markets, many of

us are looking to the new world of behavioral finance for answers to our investment conundrums. By understanding ourselves and the way we make decisions, we can often create our own systematic process for making the right choices. Whereas we once seemed to be adrift in an ocean of potential choices, with our emotions often dictating the final outcome, with the right tools we can learn to set a confident course to that safe port of call.

The problem is that behavioral finance can seem a little daunting, full of studies and inferences, and not tied together very well—until now, that is. My good friend James Montier, who literally wrote the book on behavioral finance, called *Behavioural Finance: Insights into Irrational Minds and Markets*, has now put his considerable knowledge into this small tome, *The Little Book of Behavioral Investing*.

I am no stranger to James' work. He and I worked on a lengthy chapter on behavioral finance for my book, *Bull's Eye Investing* (John Wiley & Sons). I thought I was familiar with the subject. But taking the *Little Book* on a plane ride was one of the best investments of reading time I have had in years. I found myself on all too many occasions sadly admitting to myself, "That's me!" and sighing, vowing to never again make that mistake. But at least I now know what to avoid, and I can work to improve my habits.

This is a book that I am going to have to read often, at least annually. Thankfully, James has made the book fun and the subject interesting. His naturally wry humor comes through. Whether learning why we can't seem to sell when we should, or why we choose our price targets, James gives us a blueprint to becoming better investors in 16 little chapters full of insight. No more *homo mistakus*!

I suggest you put this book on the top of your reading pile, and keep it near your desk, so you can refer to it often—to help keep you calm in the heat of the decision-making moment. So, sit back, and let James help bring out your inner Spock!

John Mauldin

Introduction

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

How could I possibly write a book about you? After all, chances are we've never met. Let alone that I know you well enough to write a book about you! The answer is actually very simple: You are a human being (unless the sales of this book have managed to reach interplanetary proportions—evidence of extreme over-optimism on my part perhaps), and we humans are all prone to stumble into mental pitfalls. This is as true in investing as it is in every other walk of life. Indeed, Ben Graham (the father of value investing) even went so far as to say "The investor's *chief* problem—and even his worst *enemy*—is likely to be himself."

Evidence of this harmful investor behavior can be found in the annual Dalbar studies, which measure the actual returns achieved by investors rather than the returns from a passive index, such as the S&P 500. They also capture the degree to which investors attempt to time their entry and exit to the market (among other things). The results aren't pretty. Over the last 20 years, the S&P 500 has generated just over 8 percent on average each year. Active managers have subtracted 1 or 2 percent from this, so you might be tempted to think that individual investors in equity funds would have earned a yearly 6 to 7 percent. However, equity fund investors have managed to reduce this to a paltry 1.9 percent per annum. This results from buying and selling at just about the worst possible point in time. Sure looks like Ben Graham was right—we really are our own worst enemies.

The goods news is that it doesn't have to be this way. We can learn to make better decisions—it isn't easy, but it is possible. *The Little Book of Behavioral Investing* will take you on a guided tour of the most common behavioral challenges and mental pitfalls that investors encounter and provide you with strategies to eliminate these innate traits. Along the way, we'll see how some of the world's best investors have tackled the behavioral biases that drag down investment returns, so that you hopefully will be able to learn from their experiences and go on to make superior returns and have fewer losses.

The Most Important Lesson of All

Whenever I teach behavioral psychology I see the audience recognizing the mental mistakes that I am talking about. However, most of the time they recognize the mistake in others, rather than in themselves. It is always Bill the trader, or Pete the portfolio manager, who illustrates the bias rather than us. We all seem to have a bias blind spot.

For instance, a group of Americans were asked to assess how likely the average American was to make a particular mental error, and how likely they themselves were to make exactly the same mistake.* The bias blind spot kicked in. The survey participants thought the average American was always more likely than they were to make a mental mistake.

However, the evidence that has been collected over the course of the last three or four decades shows that all of us are likely to encounter mental stumbling blocks at some point. So the single most important lesson I could hope to share with anyone is that the biases and mistakes we are talking about in this book are likely to affect every one of us.

Why do we all suffer these behavioral biases? The answer lies in the fact that our brains have been refined

*E. Pronin, D.Y. Lin, and L. Ross, "The Bias Blind Spot: Perceptions of Bias in Self versus Others," *Personality and Social Psychology Bulletin* 28 (2002): 369–381.

by the process of evolution, just like any other feature of our existence. But remember, evolution occurs at a glacial pace, so our brains are well designed for the environment that we faced 150,000 years ago (the African savannah) but potentially poorly suited for the industrial age of 300 years ago, and perhaps even more ill-suited for the information age in which we currently live.

As Douglas Adams, author of the sublime *Hitchhikers Guide to the Galaxy*, said, "Many were increasingly of the opinion that they'd all made a big mistake in coming down from the trees in the first place. And some said that even the trees had been a bad move, and that no one should ever have left the oceans." Leaving the trees (or perhaps the oceans) may have been our first mistake, but it certainly wasn't our last.

The Power of *Star Trek*

Psychologists have suggested that the best method of thinking about the way in which our brains work is to imagine that we have two different systems embedded within our minds. For the Trekkies out there, these two systems can, perhaps, be characterised as Dr. McCoy and Mr. Spock. McCoy was irrepressibly human, forever allowing his emotions to rule the day. In contrast, Spock (half human, half Vulcan) was determined to suppress his emotions, letting logic drive his decisions. Just in case you are the only person on this planet

who has never come across *Star Trek*, the Vulcans were a humanoid species who were noted for their attempt to live by reason and logic with no interference from emotion.

The McCoy part of our brains, which we will call the X-system, is essentially the emotional approach to decision making. The X-system is actually the default option, so all information goes first to the X-system for processing. It is automatic and effortless. The judgments made by the X-system are generally based on aspects such as similarity, familiarity, and proximity (in time). These mental short-cuts allow the X-system to deal with large amounts of information simultaneously. Effectively, the X-system is a quick and dirty 'satisfying' system, which tries to give answers that are approximately (rather than precisely) correct. In order for the X-system to believe that something is valid, it may simply need to wish that it were so.

The Spock part of our brains, which we will call the C-system, is a more logical way of processing information. It requires a deliberate effort to actually engage this system. It attempts to follow a deductive, logical approach to problem solving. However, it can only handle one step at a time (like any logical process), so it is a slow and serial way of dealing with information. Evidence and logic will be required to make the C-system believe that something is true.

Of course, we all read this and think that we are Spock. However, the reality is that the X-system handles far more

of our actions than we would be comfortable to admit. In fact, very often we end up trusting our initial emotional reaction, and only occasionally do we recruit the C-system to review the decision. For instance, when we stub a toe on a rock, or bang our head on a beam (an easy thing to do in my house), we curse the inanimate object despite the fact that it could not have done anything to avoid our own mistake!

Neuroscientists have found that the parts of the brain associated with the X-system are much older, evolutionarily speaking, than the parts of the brain associated with the C-system. This is to say we evolved the need for emotion before we evolved the need for logic. This might sound odd, but an example should help make the point obvious. Let's pretend that I place a glass box containing a large snake on the table in front of you. I ask you to lean forward and concentrate on the snake. If it rears up you will jump backwards (even if you aren't afraid of snakes).

The reason for this reaction is that your X-system reacted to keep you safe. In fact, a signal was generated the second your brain perceived the snake moving. The signal was sent on two different paths—a low road and a high road, if you like. The low road was part of the X-system, and sent the information straight to the amygdala (the brain's center for fear and risk). The amygdala reacts quickly, and forces the body to jump backwards.