

---

# Acting Rationally in an Irrational World

- ▶ **Pat Dorsey, CFA, Director of Equity Research,  
Morningstar, Inc**
- ▶ **Presentation to CFA Society of Austin**

**MORNINGSTAR®**

---

## The Importance of Temperament

“Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.”

--Warren Buffett

## The Third Source of Alpha

- ▶ From Russell Fuller:
  - ▶ 1) Better information
  - ▶ 2) Better analytical model
  - ▶ 3) Better behavior (“temperament”)
  
- ▶ #1 is tough outside of small/micro caps. Perhaps possible with low turnover and long time horizon. (Sequoia.) Subject to arbitrage if information source is replicated.
  
- ▶ #2 could be based on a quant model or an analytical insight. The former is subject to replication, and the latter is hard to do systematically.

## Better Behavior = Better Results

- ▶ #3 is admittedly fuzzier, but potentially very powerful.
  - ▶ It's systematic, since the same behavioral inefficiencies can apply to multiple investments at any point in time.
  - ▶ It's unlikely to be arbitrated away, since it's rooted in how investors naturally behave.
  
- ▶ Understanding behavioral biases and working to minimize them can give you an advantage over investors who fall into these mental traps without thinking.

## Behavioral Biases

- ▶ **Loss Aversion** – Losses hurt us 2x more than gains give us pleasure.
  - ▶ **Result:** Strategies with short-term losses are often shunned, because investors can't endure the pain – personally or professionally.
  - ▶ Lower-turnover strategies outperform. (“Time-horizon arbitrage.”)
  - ▶ **Result:** We hold onto our losers and sell our winners.

## Behavioral Biases

- ▶ **Endowment Effect** – We overvalue what we already have, be they coffee mugs or stocks.
  - ▶ Thaler's coffee mugs
  - ▶ **Result:** We don't evaluate securities on a level playing field – the ones we already own have a built-in edge.
  
- ▶ **Recency** – We weight the most recent data most heavily.
  - ▶ **Result:** Investors overreact to both good times and bad by assuming that the current state of the world persists indefinitely.
  - ▶ Consensus earnings forecasts *consistently* lag actual earnings by 9-12 months.

## Behavioral Biases

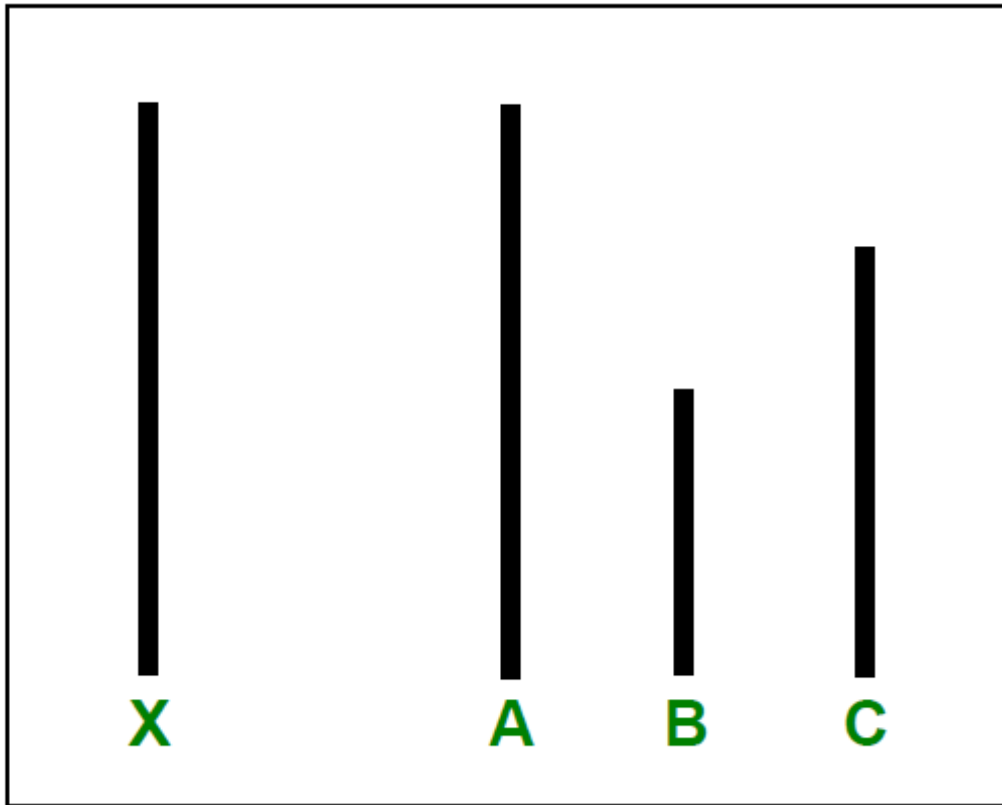
- ▶ **Confirmation bias** – We readily accept data that plugs in neatly to our personal preconceived biases, and reject data that does not support what we already think. Consistent info is processed more easily.
  - ▶ **Result:** We don't naturally seek out contrary opinions. We are highly prone to groupthink and herding.
  - ▶ “Man is incapable of understanding any argument that interferes with his revenue.” – Descartes

## Behavioral Biases

- ▶ **Social Proof** – We like to be liked. Humans are wired to be social, and investors have a hard time buying “unpopular” stocks or asset classes.
  - ▶ **Result:** Investors gravitate towards whatever is outperforming.
  - ▶ Social exclusion = physical pain
  - ▶ “Being a contrarian is like having your arm broken on a regular basis,” – James Montier
  - ▶ Anyone try pitching international stocks or REITs in the late 1990s? Or bank stocks six months ago? Or blue chips recently?

## Behavioral Biases

- ▶ **Social Proof** – The Solomon Asch Experiment



## Behavioral Biases

- ▶ **Overconfidence** – Most people routinely overestimate their own abilities
  - ▶ 70% of fund managers self-rated themselves as above average
  - ▶ Returns surveys – asked for future returns on market, personal portfolio, and average portfolio in the room. Inevitably, everyone thinks they will beat the market. But everyone also thinks they will beat the average portfolio in the room, though usually by a smaller margin.
  - ▶ Handicapping study
  - ▶ Earnings estimation
- ▶ **Key point:** More information is *not* better information

## So What Do We Do?

▶ Of course, being aware of biases is not enough. We need to codify behavioral rules into the investment process.

▶ **Avoiding Recency:**

- ▶ Look at more data. Think about mean reversion. The past ten years is a drop in the bucket in the history of asset returns.
- ▶ Grantham and Chancellor
- ▶ Try forecasting without looking at the stock chart or historical financials

## So What Do We Do?

- ▶ **Avoiding Overconfidence:** Be humble. Don't confuse success with skill. (Oil company CEOs.) Be careful not to be "Fooled by Randomness."
  - ▶ Be willing to make decisions with imperfect information. Remember the handicapping study – more information makes you more confident, but it does not necessarily lead to better decisions.
  - ▶ Kahnemann's inside/outside framework.
  - ▶ Carefully analyze your own record to separate luck from skill.

## So What Do We Do?

### ▶ **Be willing to act on imperfect data.**

- ▶ Part of the investor's job is to sort information and decide which pieces are worth acting on before the whole picture becomes clear. Waiting for complete clarity means waiting too long.
- ▶ Which was more valuable -- a century of data on home prices, or anecdotal reports of irresponsible lending behavior?
- ▶ "All of what we know is in the past, but all of the value is in the future." (Miller)

## So What Do We Do?

- ▶ **Avoiding Overconfidence:** Have written checklists
  - ▶ What do I look for in a stock or a manager?
  - ▶ When do I reconsider my initial decision?
  - ▶ Write down your decisions and the logic behind them
  - ▶ Prevents hindsight and self-attribution bias when you're assessing your performance or re-assessing a decision.
- ▶ **Avoiding Overconfidence:** Set targets *in writing* and update them.
  - ▶ Grantham's rules: "If S&P goes to XX, we change things in Y fashion."
  - ▶ If ABC goes to \$30, we'll increase position by 50%.

# So What Do We Do?

## ▶ **Avoiding Confirmation Bias:**

- ▶ Seek out disconfirming evidence. Read people who disagree with you, or even who make you annoyed.
- ▶ Try to rebut your investment thesis, rather than confirm it.
- ▶ Seek out contrary opinions

Alice: "There's no use trying. One can't believe impossible things."

White Queen: "I daresay you haven't had much practice. When I was younger, I did it for half an hour each day. Why, sometimes I've believed as many as six impossible things before breakfast."

## So What Do We Do?

- ▶ **Avoiding Confirmation Bias:** Appoint a devil's advocate
  - ▶ However, the individual must a) believe in their case and b) have an incentive to be right.
  - ▶ This is hard to do because in Montier's words, "Prickly disagreeable individuals with a strong contrarian view and the ability/desire to argue about anything would be perfect, but they don't fit well into corporate cultures."
  - ▶ The "devil" need not necessarily be an individual. Even a simple quant screen can provide disconfirming data.
  - ▶ This process is very worthwhile when done well.

## So What Do We Do?

- ▶ **Avoiding Confirmation Bias:** Use secret ballots in group situations.
  - ▶ Mitigates groupthink and bias amplification, because low-status group members are more free to express a contrary opinion.
  - ▶ Also prevents group members from seeking to gain status by agreeing with the opinions of their superiors.

## So What Do We Do?

### ▶ **Strive to Minimize Irrational Behavior:**

- ▶ Know your limits.
- ▶ More importantly, know your clients' limits. They're likely even more irrational than you are.
- ▶ Going against the grain, thinking long term, rebalancing out of rising assets (and into falling ones), challenging strongly-held opinions – these are all very, very hard things to do.
- ▶ However, *the value of acting rationally is inversely proportional to the ease of doing so.*

## Think Differently

- ▶ Have the courage to think (and act) differently
  - ▶ “It is impossible to produce a superior performance unless you do something different from the majority.” -- Sir John Templeton
  - ▶ “I would rather lose half my clients than half my clients’ money.” -- Jean-Marie Eveillard

# Acting Rationally in an Irrational World

- ▶ **Pat Dorsey, CFA, Director of Equity Research, Morningstar, Inc**
- ▶ **Presentation to CFA Society of Austin**