HOW INVESTORS SABOTAGE THEIR PORTFOLIOS: INEFFICIENT MARKETS AND IRRATIONAL BEHAVIOR

By Michael Mitchell

As the brilliant philosopher Bertrand Russell once said, "The whole problem with the world is that fools and fanatics are always so certain of themselves, and wiser people so full of doubts." Perhaps nowhere in our society is this more apparent than the financial services industry.

Michael Hirthler is an investment manager who happily concedes he is full of doubts. His investment philosophy is more about temperament than raw intelligence, more about the investment process than the short-term outcome.

That's highly unusual in today's nanosecond-oriented financial environment, where managers tout investment themes with bombast worthy of a diet commercial. Markowitz's theory that assumes a market of "rational investors" hardly seems…well, rational anymore.

Irrationality in human behavior is a favorite subject of mine, but the opportunity to write about it hasn't come up very often in my 20 years of interviewing financial advisors. The opportunity to meet a kindred spirit had me excited as I sat down to chat with Michael Hirthler, Registered Principal at LPL Financial Services in Wilkes Barre, PA.

Mitchell: Investment managers all have a particular style or approach. What's yours?

Hirthler: Our approach is multidisciplinary. We apply a variety of disciplines to both financial planning and investing, with an emphasis on behavioral economics.

Mitchell: For our uninitiated readers, what is behavioral economics?

Hirthler: Simply put, it's about how we think and why. Interestingly, the field was pioneered by a couple of non-economists, Amos Tversky and Daniel Kahneman, in their "Prospect Theory." It's based on 30 years of research as to why humans lack rational, probabilistic thinking under uncertainty. It spawned a discipline called behavioral finance that seeks to explain contradictions and irrational behavior by people making financial choices.

As it relates to our industry, behavioral finance explores the effects of psychology on investment decision-making. In other words, why do investors do some of the things they do, even when it makes no sense?

Mitchell: Can you give me an example of how irrational behavior affects people's investment decisions?

Hirthler: A 2003 Dalbar study found that over the previous two decades, while the stock market averaged over 12% annual return, the average investor gained less than 3% a year! That's less than the 3.1% inflation rate, and does not include fees or expenses. A 2006 Dalbar report — Quantitative Analysis of Investment Behavior (QAIB) — reaffirmed the previous conclusion, noting that investment return is far more dependant on investor behavior than on fund performance.

Think about the significance of that statement. Despite the ubiquitous advice by those in the financial help industry, average investors don't come close to matching the results of the funds they invest in. That's appalling. And it's largely because of investor behaviors. And this during one of the longest bull markets in our history. Think how much poorer these same investors are likely to do when the markets adjust downward, as they inevitably do. That's frightening.

Mitchell: What are some of these investor behavioral problems you mentioned?

Hirthler: I think it's important to understand that not all investors act irrationally. I believe, however, that the overwhelming majority of individual investors — what you might call *classic investors* — fall into that category.

Interestingly, most people believe they possess above-average investment skills. Do you know anyone who thinks he's a bad investor? The inability to acknowledge past mistakes or misjudgments is often at the root of this flawed perception. Wall Street analysts slow to revise previous inaccuracies is a classic example, as are those investors unwilling or unable to recognize a subjective investment decision was just that — subjective. This behavior is called *Overconfidence*.

There is a certain need to exert control over what is inherently uncontrollable. This desire propels *classic investors* toward overconfidence, accompanied by myopia and greater risk.

Classic investors are addicted to the familiar, whether it's relevant or not. They tie their expectations to a particular point of reference.

Called *Anchoring*, this behavior makes it difficult for investors to think rationally. Tulipmania and the Tech Frenzy of the late 90's demonstrate *classic investors'* disconnect between an issue's asking price and the intrinsic value of the underlying holding. A more recent example is real estate pricing.

One of the more damaging behaviors is called *Myopic Loss Aversion*. By definition, investors — as distinguished from savers or speculators — have a longer time horizon.

When investors continuously focus on short term measures, they are prone to *Myopic Loss Aversion*. This intense scrutiny forces them to perceive losses more negatively because they appear more magnified in the shorter term. Despite the fact that drawdowns are inevitable — no manager can be right all the time — *classic investors* with *Myopic Loss Aversion* are unable to accept any losses, regardless of market conditions.

The psychological need to be accepted also prompts *classic investors* to follow the crowd. They accept rather than question TV's talking heads and are subject to *Media Response*. They erroneously perceive "safety in numbers." This is not a new concept. Over 50 years ago John Maynard Keynes said "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

As they say, misery loves company.

Investors often have a skewed perception of risk. Some are willing to accept higher risk on certain assets, while averting risk on others. While often not apparent, this frailty is called *Mental Accounting*. Fear of not meeting a particular goal often pressures investors into accepting risk beyond their comfort zone.

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Mitchell: Are there others?

Hirthler: There are also behavioral biases.

Classic investors tend to believe things go right because they are smart, and things go poorly because of bad luck or uncontrollable external forces. People believe they are above-average investors and nothing bad will happen to them — bad things happen only to other people. I've never heard anyone say "I'm a lousy investor." This bias is called *Self-Affirmation*.

When investors base decisions on a desired outcome rather than on the probability of an outcome, they foment *Decision Bias*. No matter what conclusions are reached about a stock, ample support in one form or another can be found to affirm the conclusion. *Classic investors* typically make decisions and then look for support to confirm their decisions. Rational investors conduct objective research before forming an opinion, and once formed, they try to disprove their conclusion.

Selective hearing is another common affliction among *classic investors*. They embrace information supporting their opinions, reject data that contradicts their opinions and are usually guilty of taking mental shortcuts. We call that *Confirmation Bias*.

Projecting the recent past into the future indefinitely is called *Recency Bias*. *Classic investors* overreact to current conditions. A one-day market drop makes them feel more pessimistic about tomorrow and next year. Immediately after 9/11, few people would have believed our nation would go five years without another attack. That's how recency bias can affect our judgment.

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Mitchell: Are these behavioral tendencies the reason so many investors fail to reach their retirement goals?

Hirthler: They are certainly a major contributor. One reason they perpetuate — aside from people simply acting like people — is that most investors lack a structured process and the discipline it provides or requires.

In his brilliant narrative, "The Little Book That Beats the Market," Joel Greenblatt discusses how difficult it is for investors to stick to a process. He explains how psychological proclivities and biases cause investors to abandon a formula at the first sign of trouble. Since nothing works all the time, investors are constantly ditching one formula for something else that appears better at the time.

And these behavioral tendencies are not exclusive to average investors. Greenblatt illustrates this with a true story of a bright young fund manager who abandoned his proprietary discipline during a period of underperformance, selling the fund to another manager. The fund continued to be managed under the initial strategy and achieved great success. Today it is called the Hennessey Cornerstone Growth Fund.

I think a lot of investors are *Fooled by Randomness*. They somehow confuse luck with skill, and assign a pattern to random events. We have a saying around here, "Bad process, good outcome." In other words, if the probabilities are stacked against you, believing you can achieve success through skill is foolishness. A great example of being fooled is extrapolating a recent outcome (good or bad) far into the future. Think about those who bought into the Nasdaq while the bubble was being inflated. For a short time, they looked like geniuses, but when the bubble burst, they realized the skyrocket ride up was just a random event.

Mitchell: How can investors learn to stick to a process the way you do?

Hirthler: The simple answer is they must learn *patience*. The most successful investor in modern history, Warren Buffet, experienced some huge losses back in the early 70s. Many of his investors abandoned him for the safety of T Bills and missed out on one of the greatest investment appreciations in history.

Even institutional investors are not immune to these behaviors. One of my clients, a Wharton graduate, is a successful venture capitalist. He regularly speaks to major pension fund managers, and says they have the same behavioral issues as the *classic investors* we have discussed. All investors — from novice to sophisticates — have frailties that affect how they make financial decisions. The fix is not trying to eliminate our frailties but rather to gain a better understanding of how we are wired and how to overcome the behaviors that sabotage our investment decisions.

We all make mistakes. Once we recognize our behaviors and put a structure in place to avoid those tendencies we are all prone to, the focus shifts to the process rather than short-term outcomes, improving the likelihood of better results.

Interestingly, in his most recent *Chairman's Letter*, Warren Buffett touches on the hard task of finding a long-term successor for investment management at Berkshire Hathaway.

He writes, "Picking the right person(s) will not be an easy task. It's not hard, of course, to find smart people, among them individuals who have impressive investment records. But there is far more to successful long-term investing than brains and performance that has recently been good. Over time, markets will do extraordinary, even bizarre, things…We therefore need someone genetically programmed to recognize and avoid serious risks, *including those never before encountered*…Temperament is also important. Independent thinking, emotional stability, and a keen understanding of both human and institutional behavior is vital to long-term investment success. I've seen a lot of very smart people who have lacked these virtues."

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Mitchell: You mentioned earlier that your investment and financial planning process differs from most others in that it entails a multidisciplinary approach. Can you briefly explain that?

Hirthler: The genesis of our approach was an essay by Berkshire Hathaway's Charlie Munger on "Elementary Laws of Worldly Wisdom." It chronicled various models needed to become a successful investor, including psychology, finance, engineering and sociology. Our focus within these models became valuation and psychology, or sentiment.

Munger believed — and I agree — that without a latticework of models from multiple disciplines, people fail in business and life. It's like the old saw, "To a man with only a hammer, every problem looks like a nail."

Munger was a great advocate of not playing unless you have an advantage, and we adhere to that strategy. As an investment manager, it's vital to gain an advantage, to determine where you have an edge and stay there. The greatest advantage lies in understanding risks, but it's a difficult discipline for investors to embrace if their short-term focus punishes advisors trying to add long-term value.

Beating the markets is difficult because they're complex, and as we have said, our emotions and behaviors play havoc with our judgment. We think Munger had the right idea when he suggested trying to discredit everything you know. By avoiding *First Conclusion Bias,* you can help think through all the possible outcomes, as well as the probability of the end result occurring. It is also helpful to apply *inversion* in your decision making process. Thinking through your assumptions in reverse sometimes leads to the conclusion that it is mathematically impossible for something to occur.

Mitchell: I recall reading something by Mike Mauboussin about people's reticence to question their assumptions.

Hirthler: Mike is a brilliant thinker and a fellow advocate of multiple disciplines and diverse thinking. He believes the reason most investors don't spend the time to develop diverse perspectives is that (1) it's flat-out hard work, and (2) once they establish a belief, they are loathe to change it.

Mitchell: This is a fascinating perspective. I have many more questions to ask you, about your stock selection and portfolio allocation process, and also about how investors might form a framework for overcoming irrational behaviors. Unfortunately, we're out of time. Can we pick this up next week?

Hirthler: You bet.

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