

September 21, 2007

Dear clients,

I recently read a very interesting piece about a Princeton University psychology professor named Daniel Kahneman who in 2002 was awarded the Nobel Prize in economics even though he had never taken, let alone taught, a course in economics. Kahneman was recognized "*for having integrated insights from psychological research into economic science, especially concerning human judgment and decision making under uncertainty.*" His research reveals and analyzes certain human "behavioral biases." Overconfidence and hindsight bias are two examples.

All of you have heard me say how I am pretty much 80% a people manager and 20% a money manager. It's easy, and perhaps even somewhat intuitive, to think these percentages should be reversed. In fact, when I started this business in 1993 I thought the same. Nevertheless, it is encouraging and comforting to know that although traveling different paths, Kahneman and I have reached similar conclusions. Let me cite a few examples of what I mean.

When it comes to smart investing, **overconfidence** in one's beliefs can be very dangerous. I say to all prospective new clients "You'd be amazed how little I know about where the market is headed, where interest rates are headed, or just plain what stocks or market sectors look "good." I guess you could safely say I'm no Jim Cramer (the epitome of confidence personified)!! But in the next breath I say that in spite of such glaring ignorance, I definitely know how to invest smartly. You don't need to know the unknowable to invest successfully. In fact, those who pretend to know, (i.e. the overconfident investors and/or advisors) will likely make some very costly mistakes as their investing futures unfold. Along similar lines, many investors feel more comfortable and confident owning stock in the company for which they work. The thought is that by working there they should know more about the company and its unique issues and challenges than others might. Perhaps, but this doesn't necessarily translate to knowing where a stock price is headed. This is another pervasive type of overconfidence bias that must be kept in check by those who wish to keep an investment portfolio on rock solid ground.

Kahneman's concept of **hindsight bias** is also prevalent in the world of investing. So often investors and advisors tout the superb past performance of a stock or fund as if somehow this alone is meaningful going forward. It isn't! A very sensible argument can be made that the higher an investment's recent return, the lower its future expected return and vice versa. Likewise, hindsight bias can be evident when looking at the stock market as a whole. I remember in 2000, after the S&P 500 had just completed its fifth year in a row of returns in excess of 20% and just as a prolonged bear market cycle was beginning, many self-described "conservative" investors were saying they expected returns for the year of "only half" those of 1999. We know how that story played out. But hindsight bias can be just as dangerous when market performance is weak. Most of those same folks who were so bullish on the market for 2000 were now extremely bearish for 2003 – a year that saw the S&P 500 rebound and return in excess of 20% yet again. Hindsight bias is a powerful force but the best way to temper its strength is to commit to a long-term, disciplined, rational, and all weather approach to investing.

What's the message in all this? I guess the best thing we can do is acknowledge that as humans we are naturally hard-wired and susceptible to having these kind of behavioral biases. But if we can resist the never-ending temptations to impulsively act upon them, our financial lives and investment results will likely be all the better.

Be well all,

