Wisdom from Error

The ancient Greek author Plutarch wrote biographies about dozens of famous Greek and Roman men in his widely esteemed *The Parallel Lives*. He compared Alexander the Great to Julius Caesar, Demosthenes to Cicero, Pericles to Fabius Maximus, and so on. His work combined biography, history, and moral philosophy in a way that makes *The Parallel Lives* fascinating reading even today. Not surprisingly, Plutarch extracted some valuable lessons from his study of the great men of antiquity. He observed

“To make no mistakes is not in the power of man; but from their errors and mistakes the wise and good learn wisdom for the future.”

Anyone who has been investing in the financial markets over the past few years knows that mistakes and errors are an unavoidable part of the investment process.

One key to long term investment success is minimizing the number and magnitude of investment mistakes. Investors make mistakes all the time because they must make decisions in an environment of uncertainty. They must estimate probabilities, evaluate incomplete data, and assess the character and capacity of management and a host of other factors in making investment decisions. They are prone to errors every step of the way.

A relatively new field of study, behavioral finance, seeks to understand how and why investors make errors and to recommend ways for investors to “learn wisdom for the future.” Psychologist Daniel Kahneman won the 2002 Nobel Prize in Economics for work he did with Amos Tversky (1937-1996) which “…integrated insights from psychological research into economic science especially concerning human judgment and decision-making under uncertainty.”

**Sources of Investor Error**

Behavioral finance has identified over twenty basic kinds of bias which lead investors to make investment errors. We will consider a few of the most important ones.

* Overconfidence Bias

Investors, particularly men, are more confident about their investment abilities than the results warrant. Overconfidence can lead to excessive trading and an underestimation of unfavorable outcomes which fosters excessive risk taking. Behavioral research has shown that the more information we collect, the greater our confidence, even if the information is of little or no value in making sound investment decisions.

For example, back in 2007 many Wall Street analysts could spout statistics about banks’ market shares, loan growth trends, branch expansion opportunities, and the like which reinforced their confidence in recommending bank stocks. Their seeming “in depth” knowledge of the industry probably convinced a lot of investors to own bank stocks. With few exceptions, the analysts missed the “big picture” fact that real estate was in a bubble and that most banks had excessive exposure to that sector. That was the key insight for deciding whether to invest in the banking sector yet most analysts missed it.

Remedy: Challenge your investment assumptions. Seek out investment views contrary to your own.

* Self-Attribution Bias

Investors with this very common bias tend to attribute good investment outcomes to their own skill while blaming “bad luck,” poor advice, or some other external factor for poor outcomes. Of course some of the time investors are correct in identifying the cause of their investment success or failure. But behavioral research suggests that most of the time the majority of investors are prone to self-attribution bias. This bias is a form of self-deception which makes it particularly difficult for investors to learn from their mistakes.

Remedy: Try to be objective when evaluating what caused an investment to perform as it did. For example, make a list of the reasons for buying a stock and then review it when you sell. Was that loss really “bad luck” or did you miss a key factor? Was that gain due to your great insight or did a totally unforeseen event trigger your gain?

* Hindsight Bias

Behavioral research demonstrates that most people cannot accurately recall what they actually thought at the time regarding the probability of a future event. After it has occurred their memory is “Sure, I saw it coming, it was obvious.” For example, didn’t everybody know that Google’s IPO at $85 per share was a sure thing? (We confess we didn’t).

Hindsight bias damages investors’ decision making for two reasons. First, it encourages the illusion that financial events are much more predictable than they really are. This exacerbates investors’ inclination towards overconfidence. Second, it creates unreasonable disappointment when assessing results. For example, after a stock has fallen, the decline appears to have been inevitable to those with hindsight bias. They wonder, “Why didn’t I sell it before it went down?”

Remedy: Always remember that hindsight is 20-20. Real time investment decisions are always probabilistic because the future is uncertain.

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In Frank Capra’s movie, *It’s a Wonderful Life*, Jimmy Stewart plays a reluctant hero named George Bailey who is stuck in the small town of Bedford Falls. He wants to break free, travel the world and achieve his dreams of success. Yet for the sake of the Building & Loan, a local mortgage bank founded and kept alive by his recently deceased father, George agrees to stay in town and take his father’s place. Without George, the Building & Loan would have been dissolved and its clients would have fallen prey to the wiles of the rotten and miserly Mr. Potter, the “richest and meanest man in the county.”

In today’s world, Mr. Potter would be a powerful Wall Street banker who cared more about his bonus than people. George would be a community banker who put his clients’ interests before his own. After all, he sacrificed his worldly aspirations for the good of his hometown and as a result, became truly the richest man in town.

Set during the Great Depression, the movie is perhaps best known for the scene in which there is a run on the Building & Loan, coincidentally the same day that George marries his childhood sweetheart, Mary Hatch, played by Donna Reed. Using the $2,000 they had saved for their honeymoon, George and Mary convince their friends/depositors to have faith and not withdraw more than they need. While the story is more about George’s life, his role as a good-willed banker caught up in a vulnerable business illustrates the state of our financial system and economy today.

Economists continue to argue over what started the bank runs of the early 1930’s. Some blame unbridled capitalism. Others blame government policy. Whether it was a lack of regulation or redistributive subsidies that either allowed or fostered bad lending practices, the underlying problem was the same - risky loans. And as borrowers defaulted, banks failed, word spread, panic ensued and dominoes fell.

The number of banks in the U.S. peaked at around 30,000 in 1920. Back then it was largely a local business as the biggest 20 banks constituted only 14% of total assets. The table below summarizes the history since:

| Banks and Asset Concentration 1920-2009 |
|-----------------|-----------------|-----------------|
| Year | # of Banks | % of Assets |
| 1920 | 30,909 | 14% |
| 1933 | 14,771 | 27% |
| 1990 | 12,347 | 35% |
| 2009 | 7,086 | 70% |

Source: Federal Reserve Bank of St. Louis, FDIC and Federal Reserve Bank of Kansas City.

From 1920 to 1933, approximately 15,000 banks failed, with over 9,000 going bust during the four-year period leading up to the establishment of federal deposit insurance in June of 1933. The initial FDIC insurance limit was $5,000 or approximately $83,000 in today’s dollars. That was less than the current limit of $250,000, thanks mainly to last year’s increase in federal deposit insurance in June of 1933. The initial FDIC insurance limit was $5,000 or approximately $83,000 in today’s dollars. While the risk of cascading bank runs has been eliminated by deposit insurance, bank runs were only a symptom of the industry’s vulnerability to bad credit — a disease that has yet to be cured. And like a pain killer taken by an injured athlete intent on competing, the fix of deposit insurance has actually served to exacerbate the problem. Banks now have less incentive to keep their eyes on what matters most, the true condition of their borrowers.

Wise, with the advent of deposit insurance, lawmakers also instituted regulations designed to prevent speculation. However, repeals of these Depression-Era laws in the 1990’s created the powder keg that exploded during this recent credit crisis, particularly laws against interstate banking and investment underwriting. The decline in the number of banks since 1990 has occurred largely due to these repeals, with acquiring banks distancing themselves farther and farther away from their borrowers, creating more efficiencies and more leverage. Sub-prime mortgage-backed securities and their derivatives were the ultimate extreme in this game as shaky mortgages were pooled, securitized and rated “AAA” by parties who all stood to profit. As the market collapsed and Lehman Brothers was allowed to fail, the implications of systemic risk became clear. Surviving institutions were deemed “too big to fail” and thus instantly garnered undue influence on national policy by dint of the very risk they presented to the system. Accounting standards were loosened. Stress tests were not stressful. Bailouts and guarantees from the Fed and Treasury bought time in an effort to prevent collapse. The markets equated this short-term success with a return to normalcy.

While the ultimate cost of the bailouts is difficult to assess, the rising tally already exceeds $1.7 trillion. This includes the Congressional Budget Office’s recent prediction of a $200 billion net loss from the Treasury’s TARP program (rescuing banks, auto companies and homeowners). It also includes their assessment of Fannie and Freddie, which will cost almost $400 billion. Add in $800 billion for President Obama’s stimulus package, $200 billion for unemployment benefits, $100 billion to the FDIC, and you get $1.7 trillion. This figure does not include any losses on the Federal Reserve’s purchase of $800 billion of mortgage-backed securities since the crisis began.

Whitney Tilson, author of *More Mortgage Meltdowns*, observes that we’re still in the middle innings of the bursting of the housing bubble. While job losses have improved from horrific levels in recent months, historically high numbers of jobs continue to be lost and default rates continue to rise. More waves of defaults are ahead, particularly on commercial real estate loans, Alt-A mortgages, and prime mortgages. While default rates on these types of loans will be lower, the total amount outstanding is over $2 trillion, versus $1.4 trillion for sub-prime mortgages. According to Mr. Tilson, after having already written down $1.5 trillion in bad loans, the system has another $2.3 trillion to go.

In comparison to the $1.4 trillion total net worth of all FDIC-insured institutions, that’s a big number. Total earnings before loan loss provisions were $63 billion in the second quarter, or $252 billion annualized. At this rate, losses will have to be recognized evenly over the next nine years for banks to avoid further capital injections. Raising capital by selling shares in the market will dilute current shareholders, thus lowering stock prices. Obtaining government bailouts will also dilute existing shareholders as Congress will undoubtedly demand a stake for taxpayers. Like George Bailey in It’s a Wonderful Life, bank shareholders today remain vulnerable despite FDIC insurance and the government’s intent to do anything and everything to keep the system afloat. While it is clear that depositors will be spared losses up to the $250,000 limit, for investors there is little margin of safety. It remains difficult to find value in the financial sector.
**Heads For The Exits?**

During the summer a rising chorus of commentary arose questioning when the world’s central banks would begin to reverse their aggressive monetary easing policies. Those policies had been put in place last year to counter the worst global recession since World War II. In light of tentative signs that the world economy was stabilizing (“green shoots” of growth per Fed Chairman Bernanke), the main object of concern was that central banks might move too late. The Bank for International Settlements (BIS), known as the “central bank for central banks”, warned at its annual meeting in Basel, Switzerland that “Because their current expansionary actions were prompted by a nearly catastrophic crisis, central bankers’ fears of reversing too soon are likely to be particular intense, increasing the risk they will tightened too late.”

To address this concern about inflation the Group of 20 Finance ministers and central banks met in London in early September. While they welcomed signs that the global recession was nearing an end, they thought it was much too early to withdraw the extreme measures that had been put in place. They agreed, however, about “…the need for a transparent and credible process for withdrawing our fiscal, monetary and financial sector support as recovery becomes firmly secured.”

The German government has pushed hardest for the development of exit strategies, arguing that investors in government bonds needed reassurance that governments would reduce their extreme measures when the recovery takes hold. Without that reassurance, the German government fears that investors would demand higher interest rates before lending to governments. But even Germany’s Finance Minister said it was too early to set a fixed time for countries to start withdrawing their stimulus measures.

Complicating matters for the United States was the concern that some foreign governments were considering scaling back their purchases of US Treasuries due to worries about the future value of the dollar. For instance, the BRIC countries of Brazil, Russia, India, and China had a meeting in Russia to discuss trade as well as the possibility of switching some of their foreign currency reserves out of dollars into International Monetary Fund (IMF) bonds.

French President Sarkozy joined the fray by calling for the end to the dollar’s reign as the primary international currency of preference. Julian Robertson, the noted founder and chairman of the Tiger Management hedge fund, stated on CNBC “It’s almost Armageddon if the Japanese (holders of $711 billion) and Chinese (holders of $776 billion) don’t buy our debt.”

Making financing more problematic for the US was the Obama administration’s recently released forecast of the Federal budget deficit for the next 10 years. The new projection calls for a cumulative 10 year deficit of $9.05 trillion, up from the $7.1 trillion forecasted just last May. The good news, at least so far, is that foreign central banks have continued to buy a significant percentage of securities at US Treasury auctions. The new top official of Japan’s Finance Ministry said his country would keep buying US Treasury securities and supporting the dollar’s status as the world’s reserve currency. Even Russia recently changed its tune somewhat by saying that it would continue to hold US Treasuries at about 30% of its reserves.

The Federal Reserve’s Federal Open Market Committee’s policy statement on September 23 did not suggest that it was contemplating a near term increase in its overnight fed funds rate. While acknowledging that economic activity has “picked up”, committee members felt that growth would remain weak for a time and that policies in place “…will support a strengthening of economic growth and a gradual return to higher levels of resource utilization in the context of price stability.” They went on to say that they anticipated keeping the fed funds rate “exceptionally low” for “an extended period.” The vote for the policy action was 10 to 0.

Several days later in an Op-Ed for the Wall Street Journal, Fed Governor Kevin Warsh indicated that perhaps there is serious disagreement within the FOMC. That seems incongruent with the unanimous vote, but he stated that the Fed should “acknowledge the heightened cost of policy error” if the current accommodation is not removed in a timely manner. He went on to say that “…policy likely will need to begin normalization (meaning higher rates) before it is obvious that it is necessary, possibly with greater force than is customary.” Several other Fed officials made similar comments. Federal Reserve Bank of Kansas City President Thomas Hoenig, for example, said the Fed should begin raising rates “sooner rather than later.”

Looking back over 30 years, it appears that the Fed does not raise rates until the unemployment rate begins to turn down. Most economists don’t anticipate much improvement with the unemployment rate until later next year. So when will the Fed move? This will be a hard call for the Fed since it will be under a great deal of political pressure because next year is an election year. Former Fed Chairman Alan Greenspan is worried that Congress will hamper the Fed’s efforts to rein in its monetary stimulus, and that inflation might “swamp” the long term bond market. With gold prices setting records at over $1,055 an ounce and the dollar losing almost 15% of its value since March, the market is beginning to vote against the Fed’s credibility. The next few quarters will certainly test the financial and political astuteness of Ben Bernanke’s Fed.

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*Anchoring Bias*

Research shows that investors have a strong tendency to fixate on reference points such as the price they paid for a security or the most recent high (or low), when they make investment decisions. This bias is particularly evident when an investment hasn’t worked out as planned. Often an investor will hold on to a fallen stock in the hope that it will return to his breakeven price, the “anchor” price. The unbiased investor would reason more along these lines: “Given what I know today about this stock’s fundamental outlook in relation to its current price, would I buy the stock?” If the answer is “No”, the stock should be sold regardless of where it is trading relative to the original purchase price.

Remedy: Remember that the stock doesn’t know you own it and doesn’t care what price you paid for it. The past cannot be undone so focus on the future.

*Group Bias*

Groups tend to amplify rather than moderate the decision making biases that plague individuals. In addition, individuals in groups often come under peer pressure which can lead to the suppression of “contrary” ideas. A false consensus can develop (the so-called Groupthink) which promotes overconfidence. Groups also are not very good at avoiding self-attribution bias. Dysfunctional decision making is often the result.

Certainly group bias must have played a big role in the decisions of many bank loan committees, endowment fund investment committees, and mutual fund stock selection committees during the 2003-2007.

Remedies: Investment committees should consider using secret ballots in order to encourage independent thinking by their members. Another remedy would be to appoint a “devil’s advocate” to challenge the group’s assumptions and thinking.

Broader Implications of Behavioral Finance

The findings of behavioral finance regarding actual investor decision making undermine much of the conventional wisdom about investing. Investors are not, on average, coldly calculating “economic men” who always act rationally. Business and economic information is not reflected rapidly in stock prices. An entire generation of academic financial thought centered on the rational efficiency of markets now appears suspect.

Behavioral finance strongly implies that markets, since they reflect the foibles of human decision making, can often deviate from rational levels. We saw this in 1999 when dot-com start ups with no earnings and no revenue skyrocketed. We saw it again in 2005-2006 when residential real estate in many regions around the country climbed to absurd heights.

As value investors we are not immune to the investor biases mentioned earlier. But being aware of them helps us to minimize them most of the time, we hope. Unlike many institutional investors we never embraced the academic dogma about efficient markets because we recognized that people make markets. People have biases. People often bring emotional baggage to their investment process. Greed and fear periodically overwhelm markets.

If we can extract some wisdom from our errors as Plutarch suggested, we should be able to achieve satisfactory long term investment results for our clients. That’s a big “if”, of course, but we believe our knowledge of behavioral finance will definitely help.

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