Partner Talk®

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Thinking Slow at PMA

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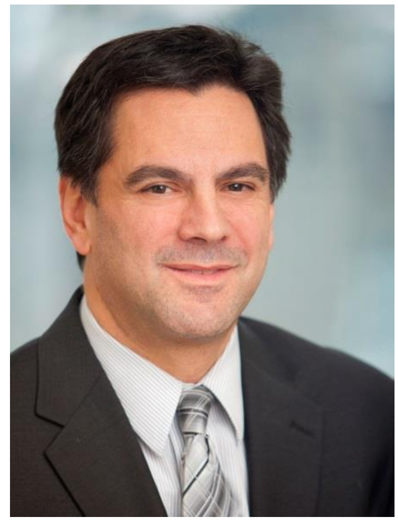

How is it that the Wall Street Journal was able to report earlier this year that for most investors "losses tend to hurt more than gains feel good"? How could such a sweeping statement be made about the weighting of losses and gains in the hearts and minds of millions of investors?

The answer to these questions may be found in two books, *MisBehaving, The Making of Behavioral Economics*, by University of Chicago Booth School of Business Professor Richard H. Thaler, and *Thinking Fast and Slow*, by Daniel Kahneman, a Professor of Psychology at Princeton University and the only Ph.D. in psychology to receive the noble prize in economics.

MisBehaving, the lighter of the two reads, is a type of intellectual biography of the relatively new fields of behavioral economics and behavioral finance, which attempt to apply scientific and quantitative methods to determine whether people and markets behave as economists would predict and how people make decisions when faced with choices. The somewhat tongue in cheek title "MisBehaving" does not refer to actual bad behavior by anyone, but instead to observed behavior that does not comport with the assumptions or models used by economists.

This author, for example, "misbehaved" this past August by deciding to attend a Phillies game notwithstanding the oppressive heat wave rolling through Philadelphia that promised to make the experience unpleasant. I had purchased the tickets in advance of the heat wave and to let them go unused seemed wasteful. To economists, however, this line of thinking is incorrect: the fact that I had spent money to buy the Phillies tickets should have been irrelevant to the decision I then faced, which was whether I would enjoy the experience or not. Because I was unlikely to enjoy the experience, and would not get my money back in any event, I should have considered that expenditure as an irrelevant “sunk cost.”

What, one might ask, does any of this have to do with investing? The answer is, in certain circumstances, quite a lot. Numerous studies have established that one of the costliest and most common mistakes made by retail and professional investors is to be backward instead of forward looking, to overemphasize sunk costs.

For example, an investor who purchased Kodak shares in September 2003 for around $21 a share would thereafter have to decide whether to hold or sell those shares. Kodak, still an iconic brand, would not close a month below $21/share for the next four years. When it finally did close under $21 in January 2008, would the investor be more or less likely to sell? The investor who would not sell because that would mean taking a small loss erred by focusing on the unchangeable past instead of the question of whether Kodak’s management could successfully transition the firm into the digital age. As stated in another book, *Common Stocks and Uncommon Profits*, "more money has probably been lost by investors holding a stock they really did not want until they could 'at least come out even' than from any other single reason."

In the course of describing the emergence of the behavioral economics field, *MisBehaving* provides many entertaining examples of biases that cause people to make mistakes when facing important decisions. For instance, Thaler studied the decisions of professional football teams on draft day – a critical day in which millions of dollars and the future of the team are at stake – and determined that teams “misbehaved” by vastly overvaluing and overpaying for an early draft pick. Teams do so because they are overconfident in their ability to “pick a winner”, rely too heavily on the perceived consensus judgment and are subject to a present “win now” bias.

Thaler in *MisBehaving* frequently acknowledges the substantial debt his field owes to Daniel Kahneman. Kahneman’s *Thinking Fast and Slow* is his effort to summarize the findings of his 40+ years of research, a summary that is accessible and mostly non-technical but one written in a more formal manner than the rather breezy style of *MisBehaving*.

One of the essential findings Kahneman describes is that the human mind reaches conclusions in one of two ways: (1) most typically, it forms a conclusion automatically and immediately using intuition, associations formed by past experiences and rules-of-thumb/short-cuts - a process of “thinking fast”; or (2) infrequently and with much greater effort, it uses logic, reason and statistics - “thinking slow” - to moderate the conclusions of the intuitive self. An essential corollary to these findings is that although most people are most of the time well served by their “thinking fast” mind, when that mind errs it does so in a systematic manner as a result of the “design of the machinery of cognition.”

Kahneman’s interests lead him to the study of how people make decisions when facing risk. He argues that his research in this area represents his “most significant contribution to behavioral economics.” This research established that under most circumstances “people are loss averse” and have an “asymmetric intensity” when comparing “the motive to avoid losses and to achieve gains.” In other words, “losses loom larger than gains.” For example, most people reject this bet: heads you win $150, tails you lose $100. People find that “the fear of losing $100 is more intense than the hope of gaining $150,” even though from a statistical perspective the bet has a positive expected value (the expected value of this bet is $25 (.5*150) – (.5*100)).

This "asymmetric intensity of the motive to avoid losses and to achieve gains" is a fact that Kahneman proves "shows up almost everywhere." Kahneman writes about a study of 2.5 million putts made by professional golfers. The hypothesis, proven correct, was that these professionals would, knowingly or unknowingly, putt more successfully when seeking to avoid a loss (a par putt to avoid a bogey) than when putting for a gain (a birdie putt). In another context, savvy negotiators will convince their counterparty that a concession (loss) they are making is particularly painful and that an equivalently painful concession will be expected in return.

Let's return to the investor who owns Kodak in 2008 and assume he was required at that time to raise funds, either by selling Kodak or a profitable asset. Many investors in that circumstances would keep Kodak and sell the "winner," all to avoid the pain of "adding a failure" to his or her record -- a mistake that would prove very costly given Kodak's bankruptcy a few years later. In short, loss aversion causes investors to hold their underperforming investments too long and to sell their winning investments too quickly.

These ideas have direct relevance to what PMA does.

First, as regular readers of PMA's monthly mailings know, these cover letters often have a heavy quantitative/statistical bent. PMA does not invest in any fund without subjecting it to a rigorous statistical analysis and evaluation. When properly used, statistics provide one objective basis for evaluation and decision-making and help to identify and eliminate shortcuts in our thinking.

Second and just as importantly, fundamental investment decisions at PMA are made exclusively by PMA's investment committee which is composed of many qualified and experienced individuals from diverse backgrounds. By ensuring that the most important decisions are vetted through a careful quantitative and qualitative discussion amongst this professional group, PMA ensures that it "thinks slow."

Investors with PMA – which includes three generations of the family members of PMA's founders – have seen the results of this "thinking slow" approach. It may seem ages ago, but this past January the market began the year with its worst 5-day start ever, a decline of 6.2% in the Dow and reaching 8.0% down by January 20. PMA advised its clients in a special January 19 email that we should not "search for patterns where none exist" and provided statistical data that the 5-day start was not significant. In June the Dow declined 5% in the two days after BREXIT, resulting in another special email from PMA on June 27 advising clients "not to make significant portfolio changes during periods of great uncertainty and volatility." Through October 2016 the Dow is up about 4% year to date.

Warren Buffet intuitively grasped all of these concepts when he stated that in investing, temperament is critical, "to control the urges that get other people into trouble." PMA believes that its process does just that.