

Your Inner Spock

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By John Mauldin

Why do we continue to make the same classic investing mistakes, generation after generation, throughout the world, in all times and in every culture? It is as if history has no meaning for each new age, yet it is there for all to read. We explore this and more in today's letter.

But first, let me offer a few observations about the current mutual fund scandals. I find it interesting that the funds which are the target of investigations still have 90% of their assets. To illustrate this point, I will first offer an insight about hedge funds. In the hedge fund world in which I mostly reside, if a manager leaves the fund, the tendency is to shoot first (redeem) and ask questions later. If there is a rumor of a problem, head for the exits. It is exactly opposite of stock trading strategy. In the hedge fund world, you sell on the rumor and buy on the news. It doesn't make any difference to the managers of the fund of hedge funds who have about 1/3 or so of all hedge fund assets. "Kill them all and let God sort them out," is the attitude. Since it takes several months (end of the quarter) to actually redeem from these funds, the knee-jerk reaction is to send in your redemption notice and then ask questions later.

That is in contrast to the average mutual fund investor, who seems to tolerate the scandals at their funds.

First, if a senior manager leaves a fund in which I am invested or following, that is a HUGE red flag for me, and should be for you. Ask questions immediately, and if you don't get the answer you like, then exit. The answer better not be, "We will soon find someone to take over the fund and make it better." Where are they going to find a budding All-Star manager to come in and take over a sinking ship? And if there is new management, then whose track record are you buying? What will he do that is different?

I would politely suggest if you have money with a fund whose manager has just been fired, especially for breaking the law, that you redeem from the fund. Do it now and avoid the rush. If you like that style, then invest in another fund with another fund family that has the same style of investing. They just do it honestly. You have lots of choices.

I do not believe that there is a pervasive systemic problem in the mutual fund industry. The vast majority of managers and funds are well run and very ethical.

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There are clearly some bad apples, though, and they need to be sorted out and soon. If you allowed late trading, we should be talking jail time.

Market timing of mutual funds is currently a legal practice, but if you showed your actual portfolio to hedge fund managers or large investors and then allowed them to trade and time, you should be required to seek a permanent job in another industry, far from the securities world, and after you have paid stiff fines. There has to be a level playing field, and the job of internal compliance and external enforcement is to insure the field stays level.

If you tell small investors that you do not allow market timing and then allow large investors to do so, I have a major problem with that, and so will the authorities. For what it's worth, it should come as no surprise that some mutual funds have what I call "weasel word" policy statements about timing in their offering documents. It makes it seem like they are against timing but gives them the leeway to actually allow it on a selective basis.

And it goes without saying that a manager or people associated with the firm should not be allowed to trade in their own funds. "Don't bother to clean off your desk. Just send us an address to forward your pictures" should be the response.

So what is the response of the Investment Company Institute (ICI), the large mutual fund lobbying group, to the scandals? Do they come out with proposals to make things more even? Solutions to a problem?

No, the ICI is trying to use this to get legislation which will benefit the funds and not the investor. Now funds can impose up to a maximum 2% early redemption fee, but they have to figure the actual costs to the fund from an early redemption. If they are lower than 2%, and they almost always are, then they are supposed to charge the lower of the actual costs or the maximum 2% fee. In practice, it is my understanding this is not done by many funds, which means those funds are in violation of the rules. They now want Congress to give them the mandate to require a minimum 2% fee (or more if the fund decides) and extend the date past five days. Some funds suggest up to 90 days. This would solve their problem of not complying with the current rules. Simply abolish the rule!

I have seen studies on the actual losses suffered by investors. They are rather small in the grand scheme of things, and certainly not on a par with the great corporate scandals or the losses in a bear market. On an industry wide scale, you could not justify a 2% minimum (repeat minimum) redemption fee.

Further, they are suggesting that buy and sell orders be at the funds by 4 PM Eastern, rather than consolidated after hours. That would mean that if you had a Schwab account, for all practical purposes you could not make a switch after about noon and get that days price. How much could investors lose by not being able to make trades closer to 4 PM? It is a whole lot more than ever would be lost by the fraction of 1/10 of 1% of

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trades that might have been made illegally after hours. The investor friendly solution would be to clean up the process and regulate the firms which consolidate the trades for all the large brokerages. But that does not benefit the funds. They know that to get later day trading privileges, many investors would move their funds directly to the fund family platforms and thus allow the funds to make more fees.

Solving the Mutual Fund Problem

If you want to solve the problem, ask for truly independent boards, which the funds will resist. Remember, an independent board could fire the manager and leave the fund family. In a legal sense, the fund is owned by its shareholders. In practicality, it is run and owned by the fund managers. You think they want to open up the possibility that an independent board could take a fund from a Fidelity manager to a Vanguard manager, or vice versa? That the board might shop fees?

Further, you can get rid of much of the problem by eliminating the “time arbitrage.” Simply mark you funds to market on a more active basis. If you and I can do it on a free Yahoo web site, it is not all that difficult for funds to do so as well. Of course, it might require them to invest a few dollars in some software and servers. Rydex now allows inter-day trading on some funds, which are actually very complicated in terms of pricing, as opposed to the average mutual fund. These Rydex funds are set up specifically for the purpose of timing. Why not other funds?

The good news is that the US Senate and House is busy trying to get a host of legislation out before Christmas, and will probably not have time to focus on this. A rush to take the powerful ICI lobbyist proposals would hurt investors. Cool heads will hopefully prevail and real reform will emerge. Representative Baker and his committee in the House are especially thoughtful and serious about reform and protecting the small investor. Let’s hope we get some fresh air next session.

At the end of this letter, I mention a web site where you can get a paper on how I do due diligence on funds and managers. While specific to what I do, it has broad applications in the principles of analysis of any investment. Many have found it worthwhile.

Bringing Out Your Inner Spock

As some of you have reminded me, today is the self-imposed deadline for finishing my book. I am missing it, but not by too much. So, instead of writing another few hours on this letter, I am going to return to one of the last chapters and see if we can get the book done by next Friday. Today, I offer you a brief portion of the material from a chapter on behavioral psychology and investing.

It will come as no surprise to learn that much of the reason that investors repeat the mistakes of their forebears is that humans have not evolved into some new specie called Homo Investus. We are still subject to the emotional pulls and pushes that

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motivated our ancestors from times even before the Medes were trading with the Persians. We make the same mistakes because the emotions with which we have been endowed were ideal for hunting and gathering, or living in small agrarian communities, but create problems for us when we take those skills to the hunting plains of Wall Street.

This next section is based upon the rather substantial and very impressive research of James Montier, the Global Equity Strategist for Dresdner, Kleinwort Wasserstein Research based in London, England. He is the author of the well reviewed and very readable (thus unusual in its field) book called *Behavioural Finance – Insights Into Irrational Minds and Markets*. He has produced a large body of work analyzing numerous books, studies and research papers on the neurological and psychological reasons for our investment decision making process. Rather than quoting his works at length, he has graciously consented to let me use a few of his papers as the base for this chapter. I have edited and added a few illustrations and examples, but the bulk of the material and conclusions is the fruit of years of his concentrated research.

We spend much of the early part of the chapter analyzing the reasons we are the way we are. I will pick us up in the middle of the chapter where we examine 5 guidelines (out of 11 in the chapter) for overcoming common investor mistakes that stem from these our basic psychological make-up. These are all associated with the problem which come from self-deception.

What a Tangled Web We Weave

Economists frequently assume that people will learn from their past mistakes. Psychologists find that learning itself is a tricky process. Many of the self-deception biases tend to limit our ability to learn. For instance, we are prone to attribute good outcomes to our skill, and bad outcomes to the luck of the draw. This is **self attribution bias**. When we suffer such a bias, we are not going to learn from our mistakes, simply because we don't see them as our mistakes. Furthermore, we make up reasons to deceive ourselves

The two most common biases are **over-optimism and over-confidence**. For instance, when teachers ask a class who will finish in the top half, on average around 80% of the class think they will!

Not only are people overly optimistic, but they are over-confident as well. People are surprised more often than they expect to be. For instance, when you ask people to make a forecast of an event or situation, and to establish at what point they are 98% confident about their predictions, we find that the correctness of their predictions ranges between 60-70%! What happens when we are only 75% sure or are playing that 50-50 hunch?

Over-optimism and over-confidence tend to stem from the **illusion of control** and the **illusion of knowledge**. The illusion of knowledge is the tendency for people to believe that the accuracy of their forecasts increases with more information. So

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dangerous is this misconception that Daniel Boorstin opined “The greatest obstacle to discovery is not ignorance – it is the illusion of knowledge”. The simple truth is that more information is not necessarily better information, it is what you do with it, rather than how much you have that matters.

This leads to the first guideline: **(1) You know less than you think you do.**

The illusion of control refers to people’s belief that they have influence over the outcome of uncontrollable events. For instance, people will pay more for a lottery ticket which contains numbers they choose rather than a random draw of numbers. People are more likely to accept a bet on the toss of a coin before it has been tossed, rather than after it has been tossed and the outcome hidden, as if they could influence the spin of the coin in the air! Information once again plays a role. The more information you have, the more in control you will tend to feel.

Over-optimism and overconfidence are a potent combination. They lead you to over-estimate your knowledge, understate the risk, and exaggerate your ability to control the situation. This leads to bold forecasts (over-optimism and over-confidence) and timid choices (understate the risk.). In order to redress these biases:

(2) Be less certain in your views, aim for timid forecasts and bold choice.

People also tend to cling tenaciously to a view or a forecast. Once a position has been stated most people find it very hard to move away from that view. When movement does occur it does so only very slowly. Psychologists call this **conservatism bias** (it can lead to anchoring which we will discuss a little later).

In the book, we show a chart which clearly shows conservatism in stock market analysts’ forecasts. We have taken a linear time trend out of both the operating earnings numbers, and the analysts’ forecasts. A cursory glance at the chart reveals that analysts are exceptionally good at telling you what has just happened. Their forecasts are clearly based upon what has just happened. They have invested too heavily in their view, and hence will only change it when presented with indisputable evidence of its falsehood.

[Note: this confirms and somewhat explains the earlier studies in this book which showed the rather sad track record of analysts – John]

Investors should note that these analysts are professionals. We tend to think of them as accountants sitting around looking at tables, numbers and mind-numbing mounds of data and coming to a rationally based conclusion. The real view is that they are all too human and their humanity shows up all too readily in their forecasts.

This leads to our third rule:

(3) Don’t get hung up on one technique, tool, approach or view. Flexibility and pragmatism are the order of the day.

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We are inclined to look for information that agrees with us. This thirst for agreement rather than refutation is known as **confirmatory bias**. The classic example is a simple four card test. You are shown four cards. Each card carries one alpha-numeric symbol. The cards you see show E, 4, K, 7. If someone tells you that if a card has a vowel on one side, then it should have an even number on the other, which card(s) do you need to turn over to see if they are telling the truth?

Most people go for E and 4 [Confession: I chose E and 4 - John]. The correct answer is E and 7. Only these two cards are capable of proving they are lying. If you turn the E over and find an odd number then the person was a liar, and if you turn the 7 over and find a vowel then you know they were lying. By turning the four over you can prove nothing. If it has a vowel then you have found information that agrees with my statement but doesn't prove it. If you turn the four over and find a consonant, you have proved nothing. At the outset the person stated a vowel must have an even number. They didn't say an even number must have a vowel!

By picking four, people are deliberately looking for information that agrees with them. Our natural tendency is to listen to people that agree with us. It feels good to hear our own opinions reflected back to us. We get those warm fuzzy feelings of content.

This is all tied up in our human quest for certainty. It is notable that we tend to associate with those who think like we do and confirm the rightness and wisdom of our judgment and views, whether on investments, politics or religion. This only re-enforces the tendency to put in concrete wrong views and notions.

Sadly, this isn't the best way of making optimal decisions. Instead of listening to the people who echo our own view we should:

(4) listen to those who don't agree with us.

The bulls should listen to the bears, and vice versa. You should pursue such a strategy not so that you change your mind, but rather so you are aware of the opposite position.

Our final bias under those related to self deception is **hindsight bias**. It is all too easy to look back at the past and think that it was simple, comprehensible and predictable. This is hindsight bias – a tendency for people knowing the outcome to believe that they would have predicted the outcome ex ante or beforehand. The best example I can think of is the US stock market over the last few years. Now pretty much everyone agrees that the US market witnessed a bubble, but calling it a bubble in 1998/99/00 was an awful lot harder than it is now! This faith in our ability to forecast the past gives rise to yet more bias towards overconfidence. This gives rise to our fifth rule:

(5) You didn't know it all along, you just think you did.

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A Little Emotion is a Good Thing

Before we depart this section on self-deception, let's look at one way in which confidence is actually necessary for investment success. Albert Wang in an article in the 2001 Academy of Sciences Journal of Financial Intermediation [Yes, there is actually such a journal – John] also finds that modest self-deception may be an evolutionary stable strategy. Wang uses evolutionary game theory to study the population dynamics of a securities market. In his model, the growth rate of wealth accumulation drives the evolutionary process, and is endogenously determined (by that it means that only the data and not some outside factors influenced the determination of winners and losers). **He finds that neither under-confident investors nor bearish sentiment can survive in the market. Massively over-confident or bullish investors are also incapable of long run survival. However, investors who are only moderately overconfident can actually come to dominate the market!**

In the world of our hunter-gather ancestors, over-confidence will get you killed. Lack of confidence will mean you sit around and starve. Cautious optimism is the right approach.

What Wang is showing is that the same is true in the new world of investments. It should be self-evident that it is necessary to play if you are going to win. Further, a willingness to accept some level of volatility and risk is characteristic of successful investors. But taking too much risk will soon get you sent to the sidelines.

It is not merely a matter of getting rid of your emotions. Like Spock on Star Trek, we all need an emotional Captain Kirk to help us sort through or decision making process. But a Spock-like detachment is something we need to keep us from the knee-jerk moments. Other parts of the chapter will show that without emotions we cannot make decisions. We need them to be healthy and balanced as investors. The key to successful investing is to be aware of the problems they cause and to find ways to keep them in check. We need to bring out our Inner Spock that is also part of our basic biological design. Over the next few weeks we will look at some other guidelines and some ways to deal with our emotions.

On the Home Stretch

I really am close to finishing my book. While it is exciting to see the end of the project near at hand, it is even more fun to go through the chapters one by one and feel happy about what I have done. I hope readers will enjoy it as much as I have enjoyed writing it.

My bride has fled the state, ostensibly to see her mother, but the more likely cause is to avoid her obsessed husband, who mutters about nothing else other than being through with this project. In an effort to induce her to return, I will work long and hard the next few days (Weekend? What weekend?) to put the final touches on this draft, so I can ship the last chapters off to my publisher.

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So with that, let me run. Oh, I promised a paper on due diligence.

Analyzing investments and investment managers is always a difficult task. To get an idea of how I go about the work, I have written a chapter on Doing Due Diligence on Hedge Funds. While this is specifically about hedge funds, I think most of the principles involved will translate to other investment areas in which you are involved. The work has received good reviews from my peers. You can read it at www.accreditedinvestor.ws (click on due diligence). That is also the site where if you are an accredited investor (basically \$1,000,000 net worth), you can subscribe to my free letter on private offerings, hedge funds and alternative investments. For complete details see the various sections on the web site, including the section on risks. (In this regard, I am a registered representative with the Williams Financial Group, an NASD member firm.)

Have a great weekend, and don't follow my example. Spend some time with family and friends.

Your typing as fast as he can analyst,

John Mauldin