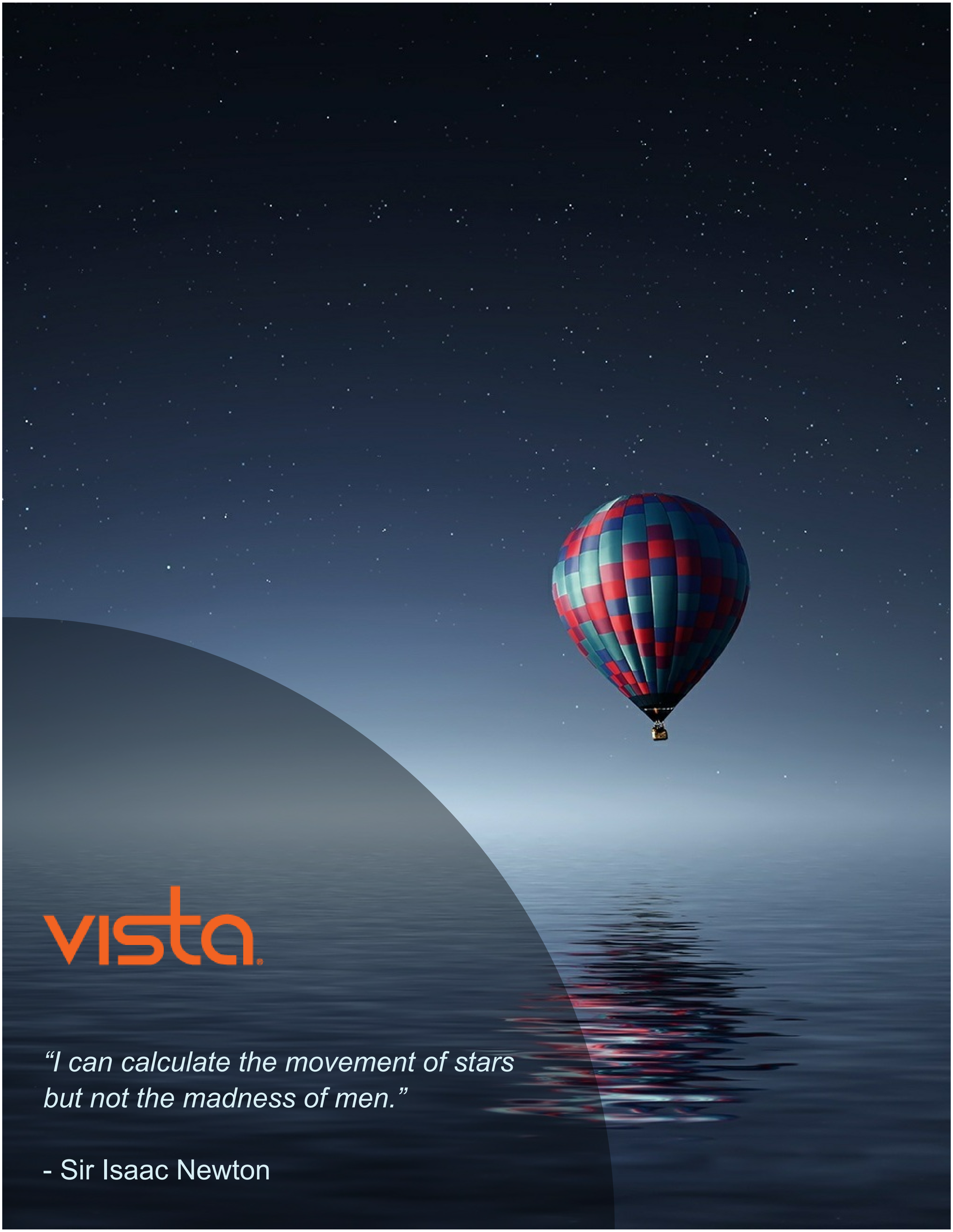

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"I can calculate the movement of stars but not the madness of men."

\- Sir Isaac Newton

In the early 18th century, one of England's most celebrated scientists, Isaac Newton, invested in the South Sea Company. South Sea had a state-given monopoly for trading in the Spanish countries of South America and the South Pacific. Newton invested a tidy sum in 1720 and then sold his stake a few months later, tripling his money. He was a happy man.

However, the stock continued to climb in price, and Newton's friends were making money in the stock, too. Later that year, Newton invested in South Sea again, that time using most of his savings. The price continued to go up to a multiple of almost 9 times his initial investment. The price then collapsed when the company's directors decided to sell their shares. Newton exited, reportedly losing about 20,000 pounds (approximately $5 million in today's dollars), a stunning loss.

What drove Newton's behavior? Many things, probably including misplaced confidence, regret, and an illusion that he was in control (after all, he was at least as smart as his friends and he could sell again at any time).

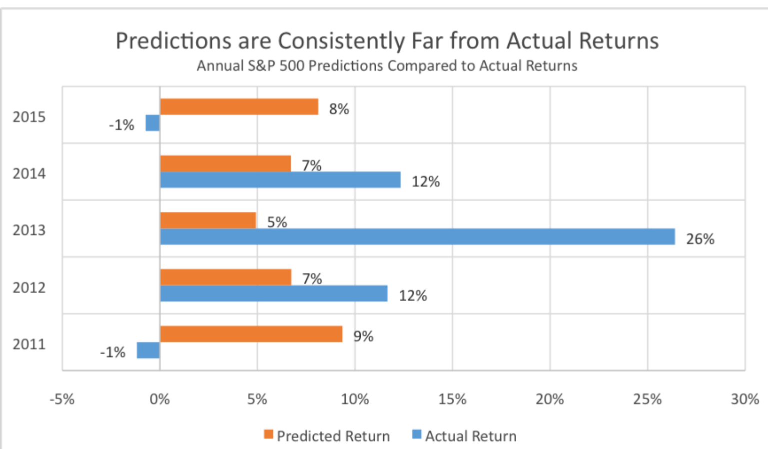
Let's focus on the control illusion because it is very popular in the psychology of investing. When we believe that we are in control, we can draw many conclusions:

- "Time to buy Apple, not Chevron."
- "Don't invest in foreign markets now."
- "Interest rates are too low, don't buy bonds."

Of course, each of those phrases has a wonderful air of certainty, and certainty is very attractive in a mostly uncertain world. The attraction is what psychologists refer to as the Illusion of Control Bias.

Humans want, at times desperately, to feel in control. This can lead to the belief that there are people who are actually in control. When things suddenly don't go as expected, though, it can lead to the belief that people are incompetent.

Where's the proof? Each year, a few organizations poll leading market strategists to get their prediction of returns for the next twelve months. Generally, it's about 13 or 14 people considered to be the best Wall Street has to offer. The chart below shows the average annual return the group predicted at the beginning of each year (blue bars) along with the actual return (orange bars). As you can see, they were never even close (and their predictions tended to average out at some pretty conservative numbers). And yet, some investors are attracted to these predictions every year, and some actually act on them.



Source: Business Insider and Morningstar Direct

Why do investors go through this exercise? Because they want to think that there are smart people who are in control of great quantities of knowledge and therefore know where the market is headed. But in the end, do they look competent? It appears not.

The markets can’t be controlled for long time periods. People vote with their investments in the short-term (should I buy Apple or Google?), but in the long-term, market growth comes from company earnings and a growing economy. Can this be controlled by any one entity? It hasn’t yet. There are too many competing interests, whether they are individual investors, pension funds, countries, or central banks.

Getting back to psychology, there are quite a few biases swaying us, most of them negative, including Confirmation Bias (only capturing information that confirms our expectations), Status-Quo Bias (the current condition won’t change), etc. All of this tends to pin a pretty negative condition on us humans as forecasters, especially when we layer on the complexities of the economies and markets. This is part of the reason the vast majority of money managers fail to meet their benchmarks.

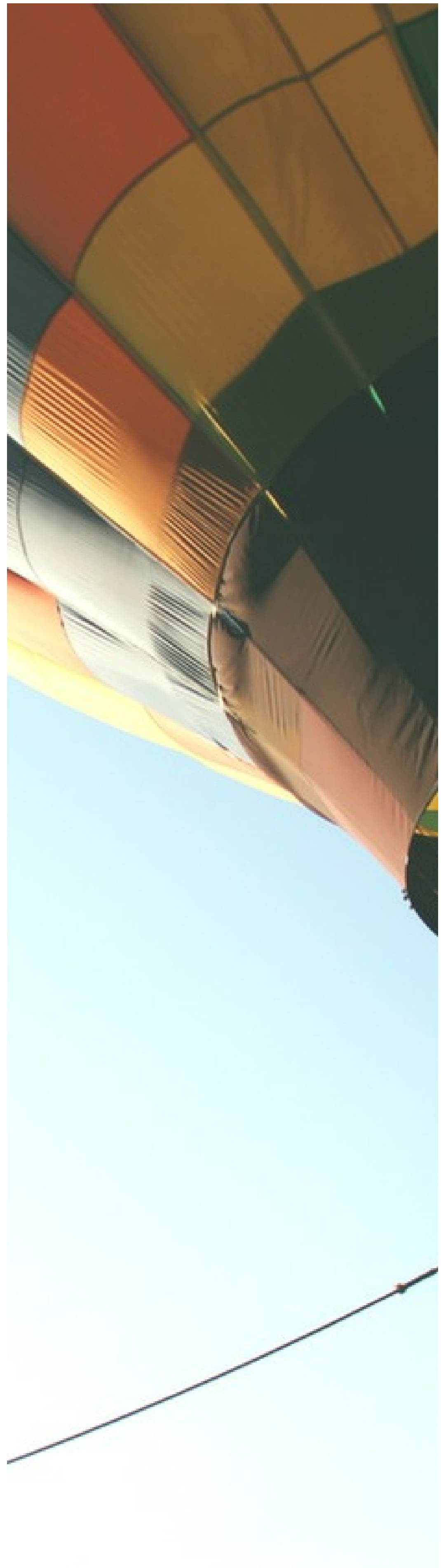
So, are we trapped in a world of worrying about unpredictable markets whose emotional swings can dash away our life’s goals and dreams in any instant? Not really. We also have behaviors that are positive for investing such as:

- **Skepticism** -- while too much skepticism can lead to paralysis, a healthy dose can steer us away from bad decisions, and
- **Optimism** -- again, while too much optimism can lead to unwarranted confidence, it also helps to keep us invested in bad markets because we want to believe that they will recover and grow. Staying invested in difficult markets eventually leads to higher long-term returns because markets tend to recover very rapidly.

As anyone who took Psychology 101 knows, the first step toward conquering our weaknesses is to acknowledge them. We all have these biases, but by keeping them in mind we can be better long-term investors.

Thanks

We hope that you found this missive interesting and, as always, we welcome your comments and questions.



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