<u>Mr. Buffett's Mr. Market</u>

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> *"Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ…Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."*
>
> … Warren Buffett

Is the stock market a person? One individual who believes so is Warren Buffett. He calls it Mr. Market. The original creator of this idea was Benjamin Graham in his 1949 book, "The Intelligent Investor". I have often wondered, why that particular title? Perhaps he looked around at the time and saw just the opposite; that people were not very intelligent about investing and he wrote the book to explain why this was the case.

Mr. Graham concluded that the market was indeed a person by virtue of the fact that it would fluctuate and that these fluctuations could be anywhere from extreme pessimism to wild optimism. He determined therefore that Mr. Market was emotional!

So here is what we have. A market that in and of itself fluctuates and tends to not be rational. It offers to buy your shares or sell your shares at a given price with the full understanding that that offer can and likely will change and do so in short order. You as an investor can decide to accept or decline that offer also knowing that the price will change. And here is where it can get dicey.

Humans by nature are emotional creatures and as investors are being tasked with making decisions about what to buy/sell and when to buy/sell. Yikes! Sounds like a recipe for disaster which is borne out by the numbers. Over the last twenty years as of December 31, 2017, the average investor's annualized rate of return of 2.6% is beating inflation by only one half of one percent(.5%). Compare this with the 7.2% return of the S&P 500 Index over the same time period. (1)

Which brings me to the topic of this missive: behavioral finance. This is a relatively new area of study. It looks to combine human behavior with economics and finance to try to understand why individuals make financial decisions that tend to not be in their own self-interest.

In psychology, **cognitive dissonance** is the mental stress or discomfort experienced by an individual who holds two or more contradictory beliefs, ideas, or values at the same time; performs an action that is contradictory to their beliefs, ideas, or values; or is confronted by new information that conflicts with existing beliefs, ideas or values. (2) (3)

If you are experiencing cognitive dissonance, the immediate response is to return to normal and restore balance. In this chaotic and disruptive world today, people are looking for consistency. Unfortunately, Mr. Market is not the place to find it. People are motivated to restore balance, and when confronted by new information that runs contrary to what they have come to believe and know, they can and will make financial decisions based on a need to restore balance. I will posit that this is not a workable investment plan. To muddle the process even further, look at the list of cognitive biases that follows that can impact decision making. As you no doubt have realized, these biases apply to other areas of life as well as finance.

When your emotions are driving your decision making, stop, take a deep breath and ask yourself, "What would a rational, prudent, objective person do?"

1. J.P. Morgan *Guide to the Markets*, 3Q 2018
2. Festinger, L. (1957). *A Theory of Cognitive Dissonance*. California: Stanford University Press.
3. *Festinger, L. (1962). "Cognitive dissonance". Scientific American. **207** (4): 93–107.*

20 COGNITIVE BIASES THAT SCREW UP YOUR DECISIONS

1. Anchoring bias.

People are **over-reliant** on the first piece of information they hear. In a salary negotiation, whoever makes the first offer establishes a range of reasonable possibilities in each person's mind.

2. Availability heuristic.

People **overestimate the importance** of information that is available to them. A person might argue that smoking is not unhealthy because they know someone who lived to 100 and smoked three packs a day.

3. Bandwagon effect.

The probability of one person adopting a belief increases based on the number of people who hold that belief. This is a powerful form of **groupthink** and is reason why meetings are often unproductive.

4. Blind-spot bias.

Failing to recognize your own cognitive biases is a bias in itself. People notice cognitive and motivational biases much more in others than in themselves.

5. Choice-supportive bias.

When you choose something, you tend to feel positive about it, even if that **choice has flaws**. Like how you think your dog is awesome — even if it bites people every once in a while.

6. Clustering illusion.

This is the tendency to **see patterns in random events**. It is key to various gambling fallacies, like the idea that red is more or less likely to turn up on a roulette table after a string of reds.

7. Confirmation bias.

We tend to listen only to information that confirms our **preconceptions** — one of the many reasons it's so hard to have an intelligent conversation about climate change.

8. Conservatism bias.

Where people favor prior evidence over new evidence or information that has emerged. People were **slow to accept** that the Earth was round because they maintained their earlier understanding that the planet was flat.

9. Information bias.

The tendency to **seek information when it does not affect action**. More information is not always better. With less information, people can often make more accurate predictions.

10. Ostrich effect.

The decision to **ignore dangerous or negative information** by "burying" one's head in the sand, like an ostrich. Research suggests that investors check the value of their holdings significantly less often during bad markets.

11. Outcome bias.

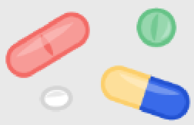
Judging a decision based on the **outcome** — rather than how exactly the decision was made in the moment. Just because you won a lot in Vegas doesn't mean gambling your money was a smart decision.

12. Overconfidence.

Some of us are **too confident about our abilities**, and this causes us to take greater risks in our daily lives. Experts are more prone to this bias than laypeople, since they are more convinced that they are right.

13. Placebo effect.

When **simply believing** that something will have a certain effect on you causes it to have that effect. In medicine, people given fake pills often experience the same physiological effects as people given the real thing.



14. Pro-innovation bias.

When a proponent of an innovation tends to **overvalue its usefulness** and undervalue its limitations. Sound familiar, Silicon Valley?

15. Recency.

The tendency to weigh the **latest information** more heavily than older data. Investors often think the market will always look the way it looks today and make unwise decisions.

16. Salience.

Our tendency to focus on the **most easily recognizable features** of a person or concept. When you think about dying, you might worry about being mauled by a lion, as opposed to what is statistically more likely, like dying in a car accident.

17. Selective perception.

Allowing our expectations to **influence how we perceive** the world. An experiment involving a football game between students from two universities showed that one team saw the opposing team commit more infractions.

18. Stereotyping.

Expecting a group or person to have certain qualities without having real information about the person. It allows us to quickly identify strangers as friends or enemies, but people tend to **overuse and abuse** it.

19. Survivorship bias.

An error that comes from focusing only on surviving examples, causing us to **misjudge a situation**. For instance, we might think that being an entrepreneur is easy because we haven't heard of all those who failed.

20. Zero-risk bias.

Sociologists have found that **we love certainty** — even if it's counterproductive. Eliminating risk entirely means there is no chance of harm being caused.

SOURCES: Brain Biases; Ethics Unwrapped; Explorable; Harvard Magazine; HowStuffWorks; LearnVest; Outcome bias in decision evaluation, Journal of Personality and Social Psychology; Psychology Today; The Bias Blind Spot: Perceptions of Bias in Self Versus Others, Personality and Social Psychology Bulletin; The Cognitive Effects of Mass Communication, Theory and Research in Mass Communications; The less-is-more effect: Predictions and tests, Judgment and Decision Making; The New York Times; The Wall Street Journal; Wikipedia; You Are Not So Smart; ZhurnalyWiki

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