

Gains from Behavioral Finance

Most of us read the behavioral finance findings of Daniel Kahneman, Amos Tversky and Richard Thaler, find it a fascinating story, are sure that we are smarter than that, but still try to defensively avoid the pitfalls. However, the opportunities are in capitalizing on the irrational decisions of other investors, which the auction or market allows us to do.

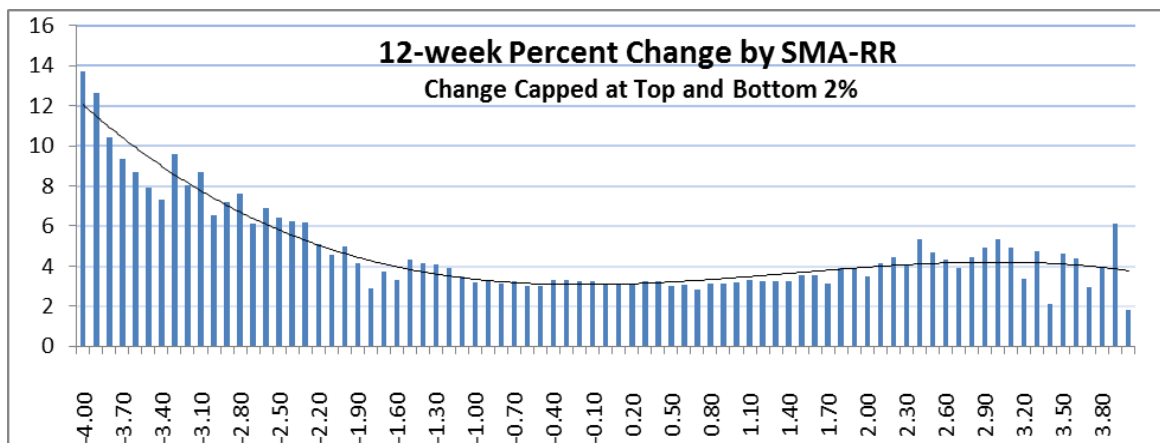
I'm always amazed at how most investment meetings and presentations frequently focus on companies that do wonderful things, have brilliant strategies and exceptional operations, with no mention made of actual returns to the investor. Most investment decisions are based on emotions, intuition and perspectives from leaders in groups or entities with which we identify, rather than from data. Therein lies the opportunity.

When our own children were preschoolers and taking swimming lessons, their energetic college-age instructors tried to persuade me to fall backwards off the three-meter board. They told me that if I didn't buckle and I kept my toes on the board as long as possible, I would gracefully enter perpendicular to the water. "Just be a log," they told me. I watched them do it several times, but it was a very different experience standing on that board. I finally had the courage to do it, and it worked. The more often I did it, the less frightening it became. That story is my metaphor for how to achieve outsized investment returns. Investing contrary to what is natural for the human psych is going to be frightening. Just like falling backwards from the high board, one must ignore the feelings and go with the data.

So what are some of the irrational decisions uncovered by behavioral finance, and how do we take advantage of them?

1. **Loss.** Investors have an irrational aversion to losses. Consequently, we can assume that falling stocks have been oversold. So buy the stocks that have gone down. An individual stock rarely falls more than 100%, but a portfolio of stocks can have a few that go up 100% and keep going. Those who cite the fact that a stock dropping 50% must have a gain of 100% to recover are talking about an artifice of mathematics, not about stocks. They are rationalizing their fear rather than being rational. The key missing variable in such talk is the probability of the drop and the probability of the recovery.

I have discovered that stocks moving up do slightly better than stocks going nowhere, but that stocks that have fallen in price do much better than stocks moving up.



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In the chart above, the horizontal axis gives the Simple Moving Average (SMA) for the rate of return for about 4,000 stocks over ten years. The vertical axis gives the percent change over twelve weeks for the different prior price changes over twenty six weeks. Starting at about one percent a week or 25% total decline, the rates of return go up as the prior losses increase. Of course there is some survivor bias built into these data, but we have reason to believe survivor bias is not a significant factor. I'm getting exceptional returns buying a portfolio of low-priced stocks that have fallen in price, have solid fundamentals, and give technical reasons to believe the price decline is over.

2. **We are comfortable with the familiar.** Buy stocks no one has heard of and that are unfamiliar. Small stocks undiscovered by analysts are where markets are most inefficient and give the best opportunities for gains.
3. **Anchoring.** Look on the charts to see the price points anchored in the minds of other investors. If a stock has traded within a horizontal range for an extended period, or frequently reversed at a certain level, that tells us that a lot of investors have anchored at that price for that stock. Expect a stall or reversal at such prices.

A variation of anchoring is to be misled by the higher numbers in a pretax or qualified account. If we are buying a \$10,000 position in an IRA account, that is a much smaller position than buying a \$10,000 position in a Roth IRA account or an after-tax account. To mix pretax and post-tax valuations on the same net worth statement without an adjustment for taxes due upon withdrawal gives us an apples and oranges net worth statement and our allocations are going to be skewed.

4. **We fall for the default.** Most retirees leave money in their qualified plans such as a Traditional IRA as long as possible thinking there is a tax advantage in returns from the pre-tax money. That is the default option and belief. People don't realize that withdrawing the money, paying the income taxes and investing in a Roth IRA results in the identical returns with more flexibility to use the money when needed. The same is true for investors in the 15% bracket if investing for gains and qualified dividends in an after-tax account. (See separate article, "Drain the Traditional IRA Early?")
5. **Now vs future.** We think short-term rather than long-term. If valuations are down 20%, what does it matter if I'm not going to sell and future valuations will in all likelihood recover? If the price of a preferred stock paying 6% drops from \$25 to \$23, my dividend dollars stay the same and the stock will eventually be called at \$25, so what does it matter? Cloonan is right that most investors will sacrifice a million dollars in their retirement account in order to avoid a temporary, unrealized loss of a hundred thousand dollars.

How do we take advantage of this dynamic? Tennant Company is a well-run manufacturer of industrial floor cleaning equipment with a long history of growth. Recently they installed a GPS device in their service fleet vehicles and found, shall we say, inefficiencies in where technicians were spending their time. Things were tightened up and more left the company than was anticipated, creating coverage issues. The stock fell about twenty percent in August, creating a buying opportunity. The stock went up fifteen percent in September alone. Short-term investors pulled the stock price down for the benefit of the long-term investor.

6. **People attach to what they own.** Because investors are irrationally over-attached to what they own, we can count on stocks that are going up becoming overvalued, and stocks that are going down becoming undervalued. We should struggle to not love the individual stock. Wait for it to go up, then sell when the momentum breaks. Focus on the criteria, not the individual stock. Test the criteria on a bundle of stocks, at least seven and preferably a dozen. If the criteria don't work, search another dataset and refine the criteria or find another set of criteria.
7. **Don't expect everyone to love your picks.** Those who follow the herd go over the cliff. Stocks heavily shorted can have some of the most dramatic gains. Mannkind (MNKD) has gone up tenfold

in six months, largely because it was heavily shorted. Buy stocks not correlated with the market. Low prices (under \$3 for sure) and deep value stocks are measures of not being liked – for now.

The main lesson from Kahneman, Tversky and Thaler is to test every intuition and presumption with data. Aggregating data from *Stock Investor Pro* can readily give a million rows of data from which to discover what consistently works. The Excel add-on XLQ can also be used to build a large dataset for use in discovery or testing specific parameters drawn from intuition or known principles such as we have presented.