

“Behavioural Investing: A Practitioner’s Guide to Applying Behavioural Finance”

James Montier, John Wiley & Sons, Ltd, 2007

Reviewed by Bruce Grantier for the Brandes Institute¹

In this new book, James Montier summarizes an immense body of research on behavioural investing and adds many new insights of his own. The combination makes this book an indispensable reference on this topic. Hopefully, this review will inspire readers to find for themselves what an important book this is and how it may help make one a better investor.

Other leading references in this field are Andrei Schleifer’s *Inefficient Markets: An Introduction to Behavioural Finance* (Oxford, Oxford University Press, 2000), and Richard Thaler’s (editor) *Advances in Behavioral Finance - Volumes I and II* (New York: Russell Sage Foundation, 1993 and 2005).

James Montier is Global Strategist at Société Générale. The contents stem from many articles he wrote as global equity strategist at Dresdner Kleinwort, where he won acclaim as a leading academic and practical authority on applying behavioural finance to investing. He also is a visiting fellow at the University of Durham and a fellow of the Royal Society of Arts.

The book’s first three sections discuss the origin of common mistakes and their roots in basic biases; the next five sections discuss behavioural phenomena. In this review, I follow the same progression; a review of mistakes and biases, followed by a discussion of a number of the behavioural phenomena which I think are potentially of great interest to Brandes constituents. These include: group decision making, fallacies of modern finance, the nature and predictability of bubbles, and an important area of behaviour – happiness – or what motivates people (correctly or otherwise).²

Starting with how the brain works, Montier discusses its two information-processing systems – the reflexive and the reflective. The two thought processes could be exemplified by the personalities of McCoy and Spock of “Star Trek” fame. The brain defaults naturally to the emotional (reflexive) system, as opposed to the objective (reflective) system. Indeed, as Montier points out, reflection requires an exertion of energy. Like the use of a muscle, it is actually tiring. Unfortunately for our decision making, two human qualities tend to complicate matters:

1. The brain is hardwired to like short-term gratification (leading to quick and easy decisions).
2. We tend to dislike social-exclusion behaviour (leading to herd-like decisions).

¹ Bruce Grantier is a member of the Brandes Institute Advisory Board. A version of this review is slated for publication in the *Journal of Investment Management*. The author thanks Barry Gillman, Director of the Brandes Institute, for introducing this book to its Board. Both Brandes Investment Partners and the Brandes Institute have hosted James Montier as a speaker at select conferences. The Brandes Institute is a division of Brandes Investment Partners, L.P.

² Daniel Gilbert is the author of *Stumbling on Happiness* (2006, Alfred A Knopf). He is Professor of Psychology at Harvard and his work is referred to extensively by Montier. Gilbert’s book *Stumbling on Happiness* was reviewed by the Brandes Institute and appears at the Brandes Institute website as *Stumbling on Value*.

Overall, despite our hopes/beliefs that we are logical decision makers, these innate tendencies often cause less-than-rational decisions.

Adding to these complications, our minds are inherently susceptible to many forms of bias – some 22, according to Montier. They fall under four basic sources with the most important being self-deception, simplification, emotion, and social interaction. Below, I describe what I believe to be the most important biases under each category:

Self-deception

- **Over optimism:** People overestimate their ability. The classic behavioural example is when members of a random group are asked if they are above, below, or average drivers. The results invariably reveal a majority of above-average drivers, a statistical impossibility.
- **Overconfidence:** People feel more confident than they should. Men exhibit this trait more than women. Studies have shown greater hubris in men leads to excessive turnover and underperformance in investing. Complicating this, behavioural experiments have shown that the more (and often irrelevant) information we accumulate, the more confident we become.
- **Self-attribution:** People credit their skill for good outcomes and blame bad luck for bad outcomes.
- **Hindsight:** People forget or overlook what they knew and when they knew it. This is also called “success at correctly predicting the past.”

Simplification

- **Anchoring:** People grasp non-relevant information, often believing they are making better decisions. Montier gives the classic example of this as the experiment by Nobel laureates, Amos Tversky and Daniel Kahneman, using a rigged wheel similar to roulette, but one which always stops at either 10 or 65.³ Two groups asked the same percentage-based question responded differently depending on which number they saw after spinning the wheel.
- **Representativeness:** People judge by appearance rather than likelihood. As Montier points out, people like a good story rather than hard facts, and if numbers are involved, people are often quite bored.⁴
- **Framing:** People can give different answers depending on the same, but differently framed questions.
- **Loss aversion:** People typically give more weight to losses than to corresponding gains.

Emotional

- **Regret theory:** The fear of being wrong may outweigh the cost in objective economic terms, and lead individuals or groups to non-optimal conclusions.

³ Montier notes that rigged experiments are a popular technique of behavioural psychologists, almost as frequently used as their other favourite technique - electrical shocks.

⁴ In a section on approaches to investing, there is a chapter on dividends. It concludes that investors view dividends as boring, small numbers. Plus, they lack the “story” that growth stocks offer. Montier notes that more than half the historic return of U.S. stocks has come from their dividends – or the “tried and true” as Jeremy Siegel wrote in *The Future for Investors: Why the Tried and True Triumph over the Bold and New*, (2005) Crown Business. The same contribution of income to total return is found in U.K. stocks. A collaborative paper of the Brandes Institute with Elroy Dimson of the London Business School is available on the Brandes Institute website.

Social Interaction

- Herding: Neurologists have found that real pain and social pain are felt in the same part of the brain. Contrarian strategies are the investment equivalent of seeking out social pain.
- Cascading: People's actions can be totally independent of their own information and totally dependent on their observation of others' actions or words.

Montier translates these biases into the “Seven Sins” of money management:

1. Enormous evidence shows investors are hopeless at forecasting, yet it may be at the heart of their investment process.
2. Investors are obsessed with information, yet more information doesn't lead to better decisions, just overconfidence.
3. Meetings with company management are overrated; management themselves are likely highly biased.
4. Investors typically think they can outsmart everyone else.
5. Investors are (increasingly) obsessed with short-term time horizons.
6. People like good stories and often enhance them to suit their own biases, while ignoring the boring facts.
7. The mind's default tendency is to believe; innate scepticism is rare, yet advantageous in investing.

Following this background of how the brain works (or doesn't work), Montier discusses a number of behavioural phenomena, among which I have chosen the following to report on: group behaviour, fallacies in modern finance theory, bubbles, and happiness.

Group behaviour is a very important topic, given most institutional investment decisions are made by committees. Montier quotes Friedrich Nietzsche: “Madness is a rare thing in individuals, but in groups. . . it is the rule.” If one has ever presented a well-researched idea to an investment committee and been rejected (not your good research, but your conclusion!), this section will be of interest.

Psychologists have found that groups amplify rather than alleviate decision-making biases. Groups tend to reduce the variance of options. They falsely lead members to increased confidence. They are not especially good at uncovering new information. Further, recalling the hard-wired anti-exclusion trait, people seek group credibility by telling the group what it wants to hear. Groups can suffer cascades (in which individuals abandon their own views), polarization (in which groups move to a more extreme version of original beliefs), and ultimately groupthink (an extreme version of polarization).

Behaviouralists distinguish between *statistical groups*, whose independent decisions actually add up to pretty good decisions, and *deliberative groups*, who tend to amplify biases. Group biases include the main ones noted previously: representativeness, framing, overconfidence, and anchoring. Montier notes that solutions to the problems of group decision making are just as difficult as overcoming individual biases. Possible solutions include: secret ballots, devil's advocates, and simply having respect for other group members.

Fallacies in modern finance theory is also a very important topic and Montier reports research challenging some of the very tenets of classical finance: beta and the limitations of CAPM, the risk in value vs. growth stocks, and the reliability of alpha and beta calculations.

The Capital Asset Pricing Model (CAPM) basically theorizes that the return of any stock is a function of its sensitivity to the market (“beta” or systematic risk) plus the return specific to that particular stock (“alpha” or specific risk), measured in terms of excess return over the risk-free rate. CAPM is elegant, intuitively appealing, and consistent with *Mean Variance Optimization* (theories that contributed to William Sharpe, Merton Miller, and Harry Markowitz receiving a Nobel Prize). Montier states that based on a wide survey of research, “Study after study have found that beta wasn’t a good measure of risk.” Citing the results of an exhaustive study by Fama and French in 2004, which estimated the beta of every stock on the New York and American Stock Exchanges and Nasdaq from 1923 to 2003, Montier notes, “CAPM woefully under predicts returns to low beta stocks, while massively overestimates the return to high beta stocks.”

Citing both U.S. and international data, Montier notes that value stocks have had lower volatility and higher returns while growth stocks have had higher volatility and lower returns. This is again the antithesis of CAPM, which postulates that risk and return go hand in hand.

If empirically observed betas do not fit the CAPM model, other questions arise. How reliable are calculations of alpha (as mentioned, that excess return after adjusting for the stock’s sensitivity to the market) and can alpha and beta really be separated? How efficient are markets if the low risk stocks outperform the high risk stocks? Does cap-weighted indexing make sense?

Given the empirically observed challenges to beta, there arises a question about the validity of the separation of alpha and beta. Some investors calculate excess return after adjusting for beta. It might be more realistic to calculate excess return *without* adjusting for beta. This approach is used in “active share,” a measure of value added, which Montier discusses.⁵ Calculating excess returns without adjusting for beta is also supported by recently published studies which show that value and growth stocks can migrate back and forth between these styles over time – thus contributing to the difficulty in explaining the expected betas of stocks.

Bubbles are a long-standing behavioural phenomenon. Montier discusses bubbles from the South Seas bubble to the dot-com bubble – their anatomy and five-stage path from formation to demise. He derived his five stages from the U.S. experience between 1991 and 2002:

1. Displacement (an exogenous shock which creates profit opportunities)
2. Credit creation (leverage of the boom)
3. Euphoria (the greater fool theory)
4. Financial distress (initial recognition of the bubble’s peril)
5. Revulsion (capitulation)

Montier identifies three stock-selection strategies designed to benefit after a bubble has burst: emphasis on balance sheet strength, earnings quality, and analysis of capital expenditures.

⁵ Active share is the degree to which a portfolio’s holdings overlap with an index. An active share of 100% means portfolio holdings have *no* overlap with index constituents.

Related to bubbles, Montier discusses their predictability vs. forecasting in general. With respect to predictability of bubbles, he notes that bubbles are often *not* “black swan events,” a phrase popularized by his friend, Nassim Taleb. The so-called black swan events often are recognized as they are occurring and denounced. Montier notes that the recent housing/credit bubble was well publicized. Economist Robert Shiller and U.S. Federal Reserve governors and senior U.S. Treasury officials gave ample warning of the excesses and the lax lending standards. Montier attributes the lack of response to bubbles to four major psychological hurdles:

1. The ever-present over optimism. We expect bubbles to affect others more than us.
2. The illusion of control. People believe that they can influence the outcome of events (the classic example of this is that people value lottery tickets far more if they can choose the numbers themselves).
3. Self-serving bias. There is an innate desire to interpret information in a way that supports one’s own interests.
4. Myopia.⁶ Consequences which may occur in the future have much less bearing on our choices the farther away they appear to be.

Montier concludes with the comment that while bubbles themselves are “predictable surprises,” the timing of the bursting of bubbles remains highly uncertain.

Montier makes a distinction between our ability to recognize bubbles vs. our poor behavioural record of responding to them. While bubbles are not that hard to recognize, forecasting accurately is a different matter. In his book he reports, “. . . an enormous amount of evidence and anecdotal experience suggests that people are very bad at forecasting.” He devotes a chapter to “The Folly of Forecasting.” Of course, this notion is not new; Montier quotes the sixth century B.C. poet Lao Tzu: “Those who have knowledge do not forecast and those who don’t have knowledge forecast.” The main behavioural culprits behind the tendency to make forecasts are overconfidence and over optimism. The main culprit behind the wide acceptance of forecasts is anchoring (as noted earlier, the grasping of non-relevant information in the belief that it will make for better decisions).

Montier notes that the best way to avoid these problems is to stop relying on pointless forecasts – much as Graham and Dodd did with their value-based strategies based on trailing earnings. In short, they strove for a better understanding of the present and what that may have meant for the future.

Happiness does not equate to money, but rather to relationships, fulfillment, reflection, and physical well-being. As the extensive behavioural literature he cites puts it: social rewards, superior work outcomes, and personal benefits. Money makes the list but as Daniel Gilbert (as mentioned, frequently quoted by Montier) put it in *Stumbling on Happiness*, after some subsistent level. Numerous studies have shown that wealth does not equate to happiness. Montier notes the term for quickly assimilating our latest improvement (or loss) in wealth:

⁶ Or as Montier says: “hyperbolic discounting if you are a geek.” (Perhaps *I* am a geek!)

“hedonic adaptation.” His best recipe for happiness is “we are the sum of our experiences not our possessions.”

I believe the book has made an invaluable contribution to behavioural finance as it reports an overwhelming body of evidence on the importance of behavioural traits in investing. My own advice – read it and keep it handy for frequent reference.

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