

“Stumbling” on Value Investing

*Stumbling on Happiness*¹ bills itself as a book about “the foibles of imagination and illusions of foresight that cause each of us to misconceive our tomorrows and misestimate our satisfactions.”

Despite the protestations of its author, Harvard University professor of psychology Daniel Gilbert, his book can be found in most bookstores in the “self-help” section. In the Foreword, Gilbert writes that if you purchase a book that indeed *claims* to make you happy, do everything it says and find yourself “miserable anyway, you can always come back here to understand why” (xvi).

One of the Brandes Institute’s goals is to expand understanding of market behavior. As such, we are interested in aspects of behavioral finance. While it doesn’t fit neatly in this genre, Gilbert’s book caught our eye. Perhaps it was the visual metaphor for life on the cover, an *overturned* bowl of cherries.

So what does *Stumbling on Happiness* have to do with value investing? And how can it help us?

First, many studies have illustrated the potential benefits of value investing. The value investing approach hinges upon taking advantage of discrepancies between a security’s *price* and its underlying *value*. Value investors tend to purchase a security when it is out of favor and selling at a discount to its true or “intrinsic” worth. Then, as other investors recognize this value, the price of the security typically rises. The Brandes Institute has published research reports (such as our “Value vs. Glamour” series) that echo the findings of various academics and illustrate the merit of value investing. Value investing sounds simple – and has been shown to work. So why don’t more people adhere to this approach?

Using excerpts and examples from Gilbert’s book, this article seeks to illustrate a variety of psychological pitfalls that may prevent us from achieving long-term success as value investors. It is designed to raise awareness of potential behavioral shortcomings and strengthen our resolve, bolster our conviction, and fortify our patience. Each section of this article draws upon a behavioral tendency and places it in the context of value investing. The titles for each section in this article are borrowed from chapter titles or subheadings in Gilbert’s book. We begin with *presentism*.

“Presentism” in the Past

Gilbert defines *presentism* as “the tendency for current experience to influence one’s views of the past and the future” (109). In practice, presentism leads us to “. . . assume that what we feel as we imagine the future is what we’ll feel when we get there, but in fact, what we feel as we imagine the future is often a response to what’s happening in the *present*”² (125).

¹ Gilbert, Daniel. *Stumbling on Happiness*. New York: Knopf, 2006.

² Italics added in this article for emphasis.

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For investors, this tendency points to the dangers of extrapolation. We may find it difficult to believe that a security whose price has gone up recently could *ever* be a bad investment. Conversely, we may have trouble envisioning a security that has been a poor performer recently ever being a *good* investment.

Gilbert notes that our ability to envision the future and accurately recollect the past is weak. He describes a number of scenarios in which we don't see all the details, but we have no problem “filling in” the missing pieces. He writes, “As it turns out, when brains plug holes in their conceptualizations of yesterday and tomorrow, they tend to use a material called *today*” (113). Forward-looking value investors need to counter the tendency to extrapolate what is happening today and look at things rationally. They need to make astute assessments of individual businesses. This may be best accomplished by comparing business values with security prices.

This may sound reasonable – until we realize that the very act of making comparisons may trigger some behavioral traps.

Comparing and Presentism

Gilbert points out that *how* we make comparisons affects our emotional response. And this may influence our decisions. To complicate matters, in many cases, we are not even aware of the types of comparisons we make. He writes, “. . . (a) value is determined by the comparison of one thing with another; (b) there is more than one kind of comparison we can make in any given instance; and (c) we may value something more highly when we make one kind of comparison than when we make a different kind of comparison” (143).

To illustrate these points, Gilbert shares an example of shopping for a new television. A shopper may want to “compare with the past” (i.e., compare the picture quality of a new set with his current set). However, at the local TV store, he gets drawn into comparing the attributes of different models in the showroom. Subtly, the decision of *whether* to buy a new set has been replaced with the question of *which* set to buy.

For the sound value investor, the essential comparison remains constant: business value and security price.

Often, market participants may get into trouble when they “compare with the past” by comparing a security's current price with its past price. Many investors “anchor” on the purchase price for a security. For example, if they buy a stock at \$40 a share, they constantly compare its performance with that original cost. Thus, if the stock price drops to \$30, they tend to get upset. But looking at a stock's current price vs. its purchase price is only one way to make a comparison. If the *value* of the business remains \$70 per share, a decline to \$30 represents an even greater discount – and perhaps an opportunity to purchase additional shares.

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In another example, Gilbert writes that “. . . people are more likely to purchase a vacation package that has been marked down from \$600 to \$500 than an identical package that costs \$400 but that was on sale the previous day for \$300. Because it is easier to compare a vacation package’s price with its former price than with the price of other things one might buy, we end up preferring bad deals that have become decent deals to great deals that were once amazing deals” (140).

What happens when we apply value-investing principles to this vacation package example? Value investors start by determining the *value* of the vacation package being offered. If it is worth \$300 and we have a chance to buy it for \$300, that would be a “fair” deal. True value investors would seek to purchase the package at a discount to its true value – perhaps for \$200. If the value of the package is indeed \$300, and the *price* recently fell from \$600 to \$500, value investors likely would pass on it. Even though the price fell by 17%, it is still \$200 (67%) above its fair value. Value investors need to compare price to the underlying value of what is being purchased. That’s true whether one is buying vacation packages – or individual securities.

In the following sections, our emotional responses in certain situations are analyzed to help increase awareness and prevent some potentially self-defeating tendencies.

Disambiguating Experience

There is an old Wall Street adage, “Never get emotional about stock.”

Great advice – but very difficult to put into practice.

According to Gilbert, there is a reason why we tend to get emotional – our brains take life’s ambiguities and reshape them into “good” things or “good” experiences once we are personally involved. A stock in the United States, one of thousands of securities we could own, is rather ambiguous – until it’s in our portfolio. At that point, investors may get emotional about their holdings. According to Gilbert, “. . . as soon as we have a stake in its goodness – our brains get busy looking for ways to think about the experience that will allow us to appreciate it” (160).

As examples, Gilbert cites studies in which consumers, job seekers, high school students, gamblers, and voters rated their appliances, jobs, colleges, horses, and candidates more positively *after* they purchased, accepted, enrolled in, wagered on, or voted for them, respectively. “A toaster, a firm, a university, a horse, and a senator are all just fine and dandy, but when they become our toaster, firm, university, horse, and senator they are instantly finer and dandier” (160).

Challenging Facts

Once we have formed an opinion about something, it can be difficult to change it. Often, our perceptions and hypotheses become our realities – regardless of the facts. Gilbert notes we tend to treat facts “unevenly” when confirming or challenging “our favored conclusion” and cites a study to illustrate this point. Volunteers were asked to judge the intelligence of another person.

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When the person being evaluated was perceived to be “funny, kind, and friendly,” little evidence was required. However, if the person being evaluated was perceived to be “unbearable,” volunteers required much more evidence. Thus, when we *want* to believe something, just a few facts can convince us.

Value investors can break their emotional attachment to the securities they have purchased, or are considering for purchase, by using a tool cited earlier in this article – regularly and objectively comparing the securities’ prices to their underlying values.

In addition, if we recognize our tendency to embrace facts that support our emotional attachments and discard facts that challenge them, we would be wise to actively seek out information that counters our conclusions when making investment decisions. And we should seek a *great deal* of this countering information. In practice, an investment committee with a healthy degree of skepticism or a group decision-making investment process can combat this tendency.

In the last section of this article, difficulties in retaining a long-term focus are addressed.

Valuing Things Differently

Why can it be so hard to be a patient investor? Gilbert may offer some insight when he writes, “The fact that we imagine the near and far futures with such different textures causes us to value them differently as well” (107).

He cites an example of paying for a Broadway show ticket. Most people would be willing to pay more for a ticket to a show tonight than a ticket to the same show next month. “Delays are painful,” he writes, “and it makes sense to demand a discount if one must endure them.” But he adds that studies show when people *imagine* the pain of waiting, they expect it to be far worse in the near term vs. the long term. “And this,” Gilbert contends, “leads to some rather odd behavior” (107).

For example, most people would rather get \$20 in a year than \$19 in 364 days. Apparently, a one-day delay that takes place in the *far* future looks (from here) to be a minor inconvenience.

But – most people would rather receive \$19 today than \$20 tomorrow because a one-day delay that takes place in the *near* future looks (from here) to be unbearable.

“Whatever amount of pain a one-day wait entails,” Gilbert writes, “that pain is surely the same whenever it is experienced; and yet, people imagine a near-future pain as so severe that they will gladly pay a dollar to avoid it, but a far-future pain as so mild that they will gladly accept a dollar to endure it” (107).

Why? We tend to imagine short-term events with greater clarity and they seem more tangible. “Indeed, studies show that the parts of the brain that are primarily responsible for generating

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feelings of pleasurable excitement become active when people imagine receiving a reward such as money in the near future but not when they imagine receiving the same reward in the far future” (107).

Value investing likely will not trigger that part of our brain that generates feelings of pleasure in the short term. (Such feelings of excitement help drive gamblers into casinos, not into value managers’ offices.) Value investing often doesn’t *feel* exciting or pleasurable. That’s because it’s not a short-term, get-rich-quick approach to the markets. But it is important to know that our short-term (or near future) emotional responses can affect our long-term rationality. And recognizing – and remaining disciplined – when we feel these short-term emotions kick in can be critical to making sound decisions for the long haul.

The Least Likely of Times

People tend to remember specific, *infrequent* experiences. We tend to remember the best and worst of times vs. *most* of the times. And this can affect decision-making. For example, Gilbert notes that when waiting in a check-out line at the supermarket, we often remember occasions when we watch a distinctive-looking person in another line zip through effortlessly while we are stuck behind a “bovine grandmother” waving coupons and “debating the true meaning of the phrase *expiration date*” for what seems like an hour. Gilbert writes, “This doesn’t really happen that often, but because it is so memorable, we tend to think it does” (199).

In another example, Gilbert highlights how our reaction to the way a movie ends influences our perception of the entire film. “The fact that we often judge the pleasure of an experience by its ending can cause us to make some curious choices” (203). There are parallels when investing: We might tend to remember with greater clarity the bad investments we have made – especially if they have happened recently and ended with great pain (large losses). The sharp emotions connected with these short-term experiences may affect our long-term investment approach. But Gilbert makes another interesting point: “Apparently, the way an experience ends is more important to us than the total amount of pleasure we receive – until we think about it” (205). In other words, if we can remove our emotional response to an experience and evaluate it rationally, we may arrive at a completely different conclusion. For successful investors, this may mean restricting our emotional reaction to a recent loss in an individual *position* and objectively evaluating our entire portfolio over the long term.

Paradise Glossed

Perhaps we have heard the theory that negative events can have twice the emotional effect as positive events. For example, a \$10,000 investment gain might earn us one “point” on an emotion-based scale. However, losing \$10,000 when investing would feel like losing *two* points. Same amount of money involved – but twice the emotional impact when losing money.

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This may be true, yet Gilbert argues that the human spirit is very resilient. He writes, “The fact is that negative events do affect us, but they generally don’t affect us as much or for as long as we expect them to” (153). So this is great news, right? Finally, it appears there is an aspect of our emotional make-up that would help make us all good, long-term investors. So why do we still have such trouble focusing on the long term? The answer: we continually subject ourselves to an assortment of short-term stimuli.

Because of tendencies cited earlier in this article, we know we often are able to quickly answer a question about the worst-performing holding in our portfolio over the last month or quarter. We know it may anger us to think about it. It might even prompt a decision to sell that security or fire the manager. But can we quickly answer a question about the worst-performing holding in our portfolio three years ago? Ten years ago? Twenty years ago?

Now what about a question regarding how much wealth our holdings have generated in the last three years? The last 10 years? Or 20 years? Successful value investors may remember a handful of clunkers, but, over time, the short-term emotional pain associated with these few holdings fades when they realize their long-term success.

Yet how often do we review holdings in our portfolio and focus on the underperformers – or read about problems with certain holdings in the financial press? Every quarter? Every month? Each week? *Daily*? A few times *each day*? It can be difficult to shed the emotional drag of short-term pain when we expose ourselves to it so frequently.

Next, we learn why it’s difficult to be patient when we feel regret.

Looking Forward to Looking Backward

Gilbert uses two investment scenarios to illustrate the influence of regret:

1. You own shares in Company A. During the past year, you considered switching to stock in Company B but decided against it. You now find that you would have been better off by \$1,200 if you had *switched* to the stock of Company B.
2. You also owned shares in Company C. During the past year you switched to stock in Company D. You now find out that you’d have been better off by \$1,200 if you *kept* your stock in Company C.

Which scenario causes more regret? Nine out of 10 people *expect* to feel more regret by switching. But Gilbert notes, “. . . in the long run, people of every age and in every walk of life seem to regret *not* having done things much more than they regret things they *did*. . .” (179). Thus, *not* switching stocks (scenario 1) causes more emotional stress.

Why? We tend to reward ourselves mentally for taking action – even if it’s the *wrong* action. Our “psychological immune system” has trouble making us feel good about inaction. In other words, doing nothing rarely feels very good.

This is another reason why value investing can be so difficult. Often, long-term success depends upon inaction. But not taking action may trigger sharp pangs of regret – especially in the short term

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if prices for holdings decline. Keep in mind that the examples Gilbert cites address a 1-year investment period. The successful value investor may have to wait three to five years or *more* to be rewarded. That can be a long time to “do nothing,” a long time for regret to build.

A colleague who read a draft of this article shared a comment on this example of regret. He said good value investors, once they have been through a market downturn or have experienced the benefits that inaction can provide, may have an intensely satisfying feeling. “Once you see how the beast works, it’s far less scary,” he said. “If you can ride it out, that experience gives you confidence and you start to look for similar opportunities in the market.”

In Closing

Gilbert writes, “Because most of us get so much more practice imagining good than bad events, we tend to overestimate the likelihood that good events will actually happen to us, which leads us to be unrealistically optimistic about our futures” (18).

This point triggers a question about value investors: Are they overly optimistic, seeing opportunities where most others see only danger? In practice, good value investors are pragmatists. They believe that optimism must be grounded in a rational assessment of business worth. They seek opportunities where their estimate of a company’s underlying or intrinsic value is well above the current price for its stock or bonds.

Keep in mind that, sometimes, the broader market’s overly optimistic view about a company may create opportunities for value investors down the road. Frequently, market participants want to believe that a new product, CEO, or strategic alliance, for example, will have a substantial impact on a business going forward. This may lead to the stock or bond prices for that business being bid up. In cases where reality doesn’t match the hype, the resulting disappointment can prompt security prices to tumble. The swing in sentiment from unbridled optimism to disappointment may create an opportunity for value investors who *rationally* evaluate security price against business value.

In closing, exposing some of our behavioral shortcomings can raise awareness of these foibles before they trigger action. This may help us make more informed decisions. We may want to think of concepts such as presentism and the different ways that we value things as “passengers” on a behavioral bus. As we travel toward our investment goals, these passengers may shout out directions or even urge us to turn around at times. However, rational value investors remain in the driver’s seat. They can recognize these behavioral influences and hear their voices, but they need not act upon them.

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SEVEN TIPS TO HELP LIMIT “STUMBLING”

Inspired by a number of points Gilbert made in his book, here is a list of suggestions designed to limit the influence of potential behavioral shortcomings and help investors make more informed decisions. This list is not endorsed by Prof. Gilbert.

1. Be wary of extrapolating recent developments far into the future. A security with recent gains may not deliver similar results in the future. At the same time, a poor-performing security recently may not continue to decline over the long term.
2. Be aware of how comparisons are made. Comparing security price with value can yield favorable results.
3. Actively seek and objectively evaluate information that counters firmly held convictions about a security.
4. Limit exposure to short-term stimuli or guard against the influence of recent developments.
5. Retain conviction – especially when doing so is difficult.
6. Remember that “taking no action” sometimes is actually a great course of action.
7. Acknowledge behavioral biases, but seek to limit their influence.

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