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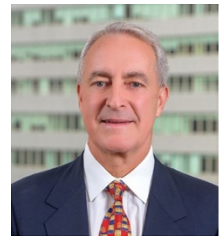

Thoughts for Investors

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The Dangers of Being Logical

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"Logic is neither a science nor an art, but a dodge"
– Benjamin Jowett, British scholar

"At the time, everything seemed perfectly logical and made business sense". This comment from Executive Golfer newsletter refers to the top dollar purchase and expansion, by a real estate company, of a southwest Florida golf course community in 2005. This same comment has been used many times when referring to investments that, in retrospect, turned out to be ill conceived. In this newsletter I will examine why investors continue to make mistakes that, at the time, seemed "logical". I will also suggest some ways to combat this most natural tendency.

"When we all think alike, no one thinks very much"
– Albert Einstein

Mankind is a social animal and most people want to conform. We seek the comfort and support that comes from crowds, be that by living in cities or rooting for "our team". When it comes to a difficult task like investing, this "herd mentality" is especially strong, as I have written previously. It is much more acceptable and comfortable to be wrong with the crowd than risk being wrong by yourself.

Independent investment thinking takes a lot more effort than simply following the crowd. In many cases it means doing your own digging, analyzing, and decision-making. Often it means facing criticism for decisions that seem "illogical".

Morningstar's system of ranking mutual funds from 1 to 5 stars is very popular. Despite all the good data contained in a Morningstar report, many investors become overwhelmed by the task of analyzing and selecting a fund, and instead make their decision by simply choosing a "5-star" fund. One can't be criticized for investing in a 5-star anything, whereas investing in a 1-star fund could be grounds for divorce. Another investing mistake is to assume that someone else did the "homework" for you. This was the case with the Bernie Madoff Ponzi scheme. So many smart people were investors, it seemed logical they must have vetted the investment already. Other past "logical" crowd pleasers include investments in tech stocks without revenues in the late 90's, or "set-it-and-forget-it", "autopilot" investing in S&P 500 index funds during the same period. Perhaps the mother-of-all "logical" investing during our times was residential real estate. It isn't that people don't see these disasters coming. There were many and repeated warnings about the "bubble" in real estate. Yet the messengers were mostly shouted down by the wisdom of the crowd. The worst part, as many investors have painfully learned, is that the more "logical" the investment, the bigger the bubble, and the longer it takes to recover.

Still another mistake is the tendency to be awestruck and blindly accept academic theories from "experts". Recall that in 1961, the noted economist Paul Samuelson (every baby boomer who took an economics class used his textbook) wrote that the Soviet Union's GNP (Gross National Product) would surpass that of the US by as early as 1984.

Another logical mistake is equating volatility to risk. "Risk" is very difficult to calculate, whereas "volatility" is very easy to calculate. There is plenty of historical volatility data from which to build asset allocation models. Risk, on the other hand, can come out of left field and is therefore virtually impossible to "calculate". We have long known Japan is prone to earthquakes, yet how was one to calculate a nuclear disaster in addition to an earthquake. The Department of Defense has a term for risks that are "substantially without precedent". It calls them "wicked problems". 9/11 may qualify as one. How does an investor build the potential of "wicked problem" risks into an asset allocation strategy? Thus, volatility is often used by experts as a proxy for risk, and I believe that is a grave mistake.

"Everything that can be counted does not necessarily count; everything that counts cannot necessarily be counted"

– Albert Einstein

Today it is logical to assume that many of the world's challenges, both real and imagined, are either insurmountable or only surmountable at the cost of the world's standard of living. From terrorism, the world running out of (insert word here), sovereign debt, and unemployment, to the resurrection of that oldie-but-goody – overpopulation, there are, indeed, lots of things one can worry about. Yet I recently returned from the DB Global Industrials and Basic Materials Conference in Chicago with a different perspective than this. Twenty-seven companies updated me on the state of their business and their outlook for the global economy. Of course, their guess on the near-term direction of the global economy is as good as mine (or yours). While it is easy to be awed by advancements in healthcare or technology, what was impressive in Chicago was the effort that many industrial companies are putting into research and development, productivity improvement, cost cutting, revenue generation, profit margin improvement, development of their workforce and return to shareholders. Equally impressive was the strong financial condition of many of these companies. Not every effort they make will be rewarded, and inevitably mistakes will be made. Yet that is why a strong financial condition is important. Profits can be used to pay for those efforts. Perhaps more importantly, there is an even bigger repository from which to draw the answers to today's challenges: the human mind. Until we have exhausted the capacity of the brain, mankind will prioritize and address its challenges.

"No, no, you're not thinking; you're just being logical"

– Niels Bohr, Nobel Prize-winning Physicist

So how does an investor guard against decisions that seem perfectly logical and make business sense now, but risk disaster in the future? The most important way is to "think". Are you acting based on past performance, emotion, the herd mentality, or comfort? Simply adopting a contrarian approach or believing a "secret formula" exists is not the answer either. These are not substitutes for thinking. In my opinion, the greatest approach to thinking was offered by St. Augustine's motto Audi Partem Alteram, "Hear the Other Side" which I have adopted as my motto. Listening to the "other side" of a discussion is the best way to combat the natural tendency to believe that the logical answer is the correct answer. When investing, I believe Audi Partem Alteram should be combined with my "Cardinal Rule of Investing" which states that "For every buyer there is a seller, and for every seller there is a buyer; and they both think they're right". Before you assume your "logical" answer is the correct one, ask yourself why the other side of the trade thinks their decision is the "logical" one.

In summary, it is "logical" (and lifesaving) to wait for a green light before crossing the street. Yet, in my opinion, "logical" involves how to act in the present, whereas investing is about how to act for the future; thus sometimes putting "logical" and investing at odds. As I have explained above, what may, in fact, seem logical today might be illogical in the future. So when investing, the answer is not to automatically act logically (or illogically), nor is it to follow the crowd. Rather, the answer is to think.

AUDI PARTEM ALTERAM

Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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