Private: Marbles and Treasure

BY KENNETH E. LEE ON *APRIL 11, 2018*

"Don't lose your marbles," I said to my seven-year-old son as he joyfully played with his two newly acquired glass marbles. He and I were sitting together at bustling Nomad Pizza in Hopewell, NJ. Although my admonition clearly registered as relevant to him in light of his enthusiastic play, he was having too much fun to stop. First a marble fell but was easily recovered. Then they both fell and subsequently bounced uncontrollably away from him off the uneven brick floor under nearby tables. This sent him scampering to retrieve them in fear they would be lost, an emotional and stressful experience. Immediately after securing the marbles, and on his own accord, he deposited them into my coat pocket for safekeeping.

As it turns out, research shows that adults (including investment advisors!) are subject to an “availability bias,” which causes humans to give too much weight to (often recent) events that easily come to mind at the cost of seeing the bigger picture, despite the common narrative that we adults behave rationally.[i] This bias partially blinds us to risk; but the same human bias is helpful in keeping marbles safe once negative experiences have occurred. Unfortunately, these natural inclinations can have unproductive repercussions in investing. Is there anything we, as market participants, can learn about our own nature from my son’s experience? And, perhaps more usefully, can we apply lessons about how *other* market participants behave and why? How do these observations fit into the broader literature on investor psychology?

Our primary economic and finance theories, such the rational-expectations hypothesis[ii] and the efficient market hypothesis[iii], rest on the foundational assumptions that people act rationally and that facts matter. In recent decades, academics have more closely studied market anomalies and non-rational drives of humans “losing their marbles,” in the idiomatic sense of the phrase. The result is that academia has asked, and partially answered, many questions about investor psychology with such terms as loss aversion[iv], contagion [v], and mental accounting[vi]. These factors do help to explain many of the phenomena around us in securities markets[vii]. If certain irrational behaviors are endemic to markets, then being aware of these behaviors and their effects should enable us to make better decisions as market participants.

Research fairly definitively shows that investor psychology matters *at least* to short-run securities prices. My son’s experience reminded me of a few related lessons I have learned while investing over the last couple of decades:

1. Risks are often ignored until they are experienced; then, when experienced, they are given too much weight because of the emotions surrounding the experience. People tend to project recent events into the future, rather than taking a longer view. The result is that markets tend to overshoot[viii].
2. Money is, for most, precious, and therefore investing often carries emotional weight that complicates making rational investment decisions based on facts. These emotions are often magnified by factors such as volatility, the media, and politics.
3. Loss is unpleasant. Loss makes us want to take all our marbles and go home, or at least leave them in our pockets, whether or not it is the right thing to do at the time.
4. Research is important in investing; but my experience is that above-average returns are not possible unless thorough research is combined with patient decision-making that is against the grain of “normal” investor psychology.
5. In our imperfect world a loose marble may bounce or roll randomly for a while. Often, the prices of securities move against us (occasionally for extended periods of time) despite the value that is being created by the people running the underlying businesses.
6. Sometimes we have to scamper along the floor to gather the treasure, which is easy enough for a healthy seven-year-old with a bottomless reservoir of energy. Investors, however, need thorough preparedness and a reservoir of available capital, which I usually refer to as keeping “dry powder.”

The pizza was great, and my son asked if he could put the marbles in his own pocket for the walk home. I am happy to report that these precious objects made it safely to the marble collection in his secret hiding place that night.

At his request, we read a few of Aesop’s *Fables* before turning out the light, although he declined to read his sister’s favorite, *The Travelers and the Bear[ix]*.

Crucially, nobody lost any sleep over the marbles.

Kenneth E. Lee

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[i] Kahneman expands on this heuristic in Kahneman, D. 2011. *Thinking, Fast and Slow*. Farrar, Straus & Giroux. Initial groundbreaking outline of this idea was Tversky and Kahneman, “Judgement Under Uncertainty: Heuristics and Biases,” *Science*, vol. 185, 1974 (reprinted in Kahneman 2011).

[ii] This typically refers to economic markets as a whole rather than individual behavior, formalized by: Muth, John F. (1961). *“Rational Expectations and the Theory of Price Movements”* (PDF). Econometrica **29** (3): 315–335. *doi*:*10.2307/1909635*. reprinted in Hoover, Kevin D., ed. (1992).

[iii] Developed by Eugene Fama, this theory assumes that all available information regarding an asset price is embedded in the current price and therefore that no excess returns can be gained from research. One of my favorite books, and now an investment classic, is *A Random Walk Down Wall Street*, by Burton G. Malkiel. See also S. Grossman, J. Stiglitz, “On the impossibility of informationally efficient markets,” *American Economic Review*, 70 (1980) 393–408.

[iv] In short, people would rather *not* lose money than make it: D. Kahneman, A. Tversky, “Prospect theory: An analysis of decision under risk,” *Econometrica* 47 (1979) 263–291; A. Tversky, D. Kahneman, “Advances in prospect theory: Cumulative representation of uncertainty,” *J. Risk Uncertainty* 5 (1992) 297–323.

[v] Questions about contagion have typically turned on the extent to which psychological rather than economic factors play a role in co-movement of asset prices: Shiller, R.J. 1984. “Stock prices and social dynamics.” Brookings Papers on Economic Activity 1984(2), 457–98. Shiller, R., 1989. “Comovements in stock prices and comovements in dividends.” *Journal of Finance* 44, 719–729; Pindyck, R., Rotemberg, J., 1990; and Pindyck, R., Rotemberg, J., 1990. “The excess comovement of commodity prices.” *Economic Journal* 100, 1173–1189.

[vi] Mental Accounting relates to investor attachment to prices rather than economic value of securities owned: Benartzi, Shlomo; Thaler, Richard H. (1995). “Myopic Loss Aversion and the Equity Premium Puzzle.” *The Quarterly Journal of Economics* **110** (1): 73–92. doi:10.2307/2118511.

[vii] Much of this was of course well-documented in the often-cited publication in 1841 of *Extraordinary Popular Delusions and the Madness of Crowds* by Charles Mackay that describes bubbles and manias such as the Dutch Tulip Mania of 1619-1622.

[viii] Robert J. Shiller. “Do stock prices move too much to be justified by subsequent changes in dividends?” *American Economic Review*, 71:421—436, 1981.

[ix] This is one of my favorite stories, and probably the topic for a future letter.