

# perspective

By Frank K. Martin, CFA  
Managing Partner

## David and Goliath

When the Dow Jones average effortlessly hurdles another barrier, most recently at 5,000 in November 1995, with equanimity, when Wall Street pundits pronounce matter-of-factly that 10,000 is within easy reach before the end of the millennium, when all talk is about return on principal, not return of principal, when the general euphoria in financial markets has spread like wildfire, reaching parts of the investment landscape that have historically been least flammable, when the writer himself feels an occasional vague, almost subconscious urge to jump aboard the band wagon, perhaps it's time to think a little about emotions that surreptitiously invade and sometimes compromise the process of rational thought.

Containing and controlling our emotions, assuming they are even recognized, often takes inordinate amounts of self-discipline. If you have ever exploded into a blind rage or were paralyzed when you experienced white knuckle fear, you know the difficulty in overriding the fight or flight impulse with measured and sensible thought! To be sure, investors' ebullience, the emotional state of mind most conspicuous today, is not as high on the scale of emotional stimulants as is anger or fear, but it nonetheless is a force to be treated with wariness. Identifying one's feelings and emotions and then short-circuiting the response they might otherwise evoke with your rational mind requires special mental attributes recently popularized in a book on the subject of "emotional intelligence," of which more later.

What did Ben Graham, the dean of fundamental security analysis, mean when he observed that investment is most successful when it is "business-like?" His writings suggest a particular mindset, a rational paradigm through which investment choices are to be systematically evaluated. The process he advocated emphasizes beginning with a deliberate and sensible evaluation of the facts, followed by actions that reveal an independent, experienced, and educated mind. The decision-mak-

ing process is to be calculated and purposeful, bordering on the mechanical. That his rational mind became so dominant is not surprising. Graham came within a whisker of losing all of his financial assets during the stock market debacle of the early 1930s. More importantly, his shattered self-confidence was never fully restored, and his near disaster experience perhaps unnaturally heightened his sensitivity to the threat of apocalyptic risk, however remote that possibility then was. By apparently not recognizing the full scope and power of mania that gripped Wall Street in the late 1920s as it metamorphosed into the world's largest and most alluring casino, he was unprepared for the shocking and unprecedented magnitude of the devastation that followed when the speculative bubble finally burst. Avoiding the first phase of the crash, he plunged back into common stocks in 1930, only to lose most of his wealth by 1932 when the carnage was finally complete, when sentiment sank to its lowest ebb. He learned the power of emotion run amok in the most painful and, in his case, crippling of ways.

Please do not conclude from what was just said that the writer believes conditions today are similar in magnitude to those which prevailed in Graham's time. My familiarity with the ever escalating and increasingly perilous transformation of attitudes and expectations that culminated in the Crash and Depression is certainly not based on first-hand experience. While I have read every good book on the episode of the late 20s to early 30s, my understanding is from second hand sources only! That we are under the sway of some form of collective emotion that is growing in intensity seems quite apparent; as to where it is along the developmental continuum, only the future will tell. It should go without saying, however, that this piece would not have been written unless the writer thought we are closer to the end than the beginning.

In the often-quoted "Mr. Market" anthology, Graham acknowledged the existence of emotion and its powerful role in the investment decision-making process. Following are Graham's own words from the classic, *The Intelligent Investor*.

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Imagine that in some private business you own a small share that cost you \$1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.

If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a \$1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.

Graham simplifies, "Basically, price fluctuations have only one significant meaning to the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."

Graham's use of the "Mr. Market" parable to suggest that a large and influential number of market participants are at times somehow possessed, en masse, by certain primary emotions reveals his understanding of the powerful behavioral anomalies which manifest themselves when seemingly rational individuals submit unconsciously to the will of the crowd. He understood that the behavioral consequences of the psychology of a crowd are often counterproductive long before "behavioral economics" began to attract attention. Because of the difficulty in applying the principles of scientific inquiry to test the validity of theories of crowd psychology, the subject has not received as much attention from the scientific community as one might naturally think. The anecdotal evidence is both abundant and intuitively compelling, but not easily verified.

Several fascinating, although dated books offer theories

on crowd psychology and powerful examples of mass delusion that are quite illuminating. *The Crowd*, written by a Frenchman, Gustave Le Bon, who died in 1931, and whose work was published in 1960 (and long since out of print) and Englishman Charles McKay's *Extraordinary Popular Delusions and the Madness of Crowds*, published in 1952, to which I have made frequent reference in the past, should find a home on every serious investor's bookshelf. Buruch, another great and global thinker and eminent investor from the generation before Graham, also acknowledged the importance of the understanding of crowd psychology to his investment success, in the Foreword he wrote for McKay's book. Said he: "A group of geniuses, when functioning as a crowd, may have the effective intellectual capacity of an imbecile. Just because the theories cannot easily be scientifically confirmed, they are not made less relevant."

Not only did Graham identify the existence and momentous power of popular delusions, he also saw in their presence great advantages for the wise investor who forms an educated and independent opinion of the value of his holdings. It is Mr. Market's manic-depressive nature that exacerbates the fluctuations in security prices and provides windfall opportunities for those who recognize the critical distinction between taking Mr. Market's advice and merely taking advantage of his emotional extremes. Unfortunately, a great many investors have no more learned basis for forming "business-like" opinions as to the value of a security than I have for judging the worth of a Van Gogh or a Picasso. Mr. Market becomes their only practical alternative. Stock tickers and pages upon pages of price quotations in newspapers across the country, the mediums through which Mr. Market expresses himself, are of little or no value to the great investors. They are far too busy focusing on what is important.

The best seller, *Emotional Intelligence*, by Daniel Coleman offers a contemporary slant on the subject of human effectiveness. In a very real sense, alleges Coleman, we have two minds, one that thinks and one that feels. These two fundamentally different ways of knowing, interact to construct our mental life. One, the thinking or rational mind, is the mode of comprehension we are typically conscious of — it is thoughtful, able to ponder and reflect. But alongside that there is another system of knowing — impulsive and powerful, if sometimes illogical — the emotional mind. The emotional/rational dichotomy approximates the folk distinction between "heart" and "head."

There is a steady gradient in the ratio of rational-to-emo-

tional control over the mind. The more intense the feeling, the more dominant the emotional mind becomes, and the more ineffectual the rational. In most instances the two work well together in constructive harmony: feelings are essential to thoughts, just as thoughts are to feelings. When emotions surge, the balance tips and the emotional mind captures the upper hand, overwhelming the rational mind. Coleman posits that evidence of superior emotional intelligence can be seen in the ability to control impulse and to delay gratification, to regulate one's moods and keep distress (or perhaps even eustress) from overwhelming the ability to think.

"Contagion", the term used by Le Bon to describe how the emotion of the crowd infiltrates the minds of its members, may bridge the gap between Coleman's assessment of individual propensities and Le Bon's observations about the conduct of groups of closely linked persons. Le Bon believed that in circular-fashion the crowd agitates and reinforces the emotional mind of the individual.

"Greed" is a poor word choice to characterize the feelings that drive individuals to what all too often proves to be irresponsible behavior in an aged bull market. According to Le Bon, individuals may be motivated by little more than the natural instinct to belong, to be part of a group. Willing submission to the will of any group could also be an outward sign of an inner fear of being alone. When others appear to be making money effortlessly, certain emotions well up inside us and the behavioral response for most is quite predictable. Whatever forces are at play when prices are rising, they are likely to be less potent than when the market is in the death grip of the bear. The fear of total financial annihilation, of being wiped out, is all consuming. That is why bear markets are more condensed, desperate, and less circumspect than bull markets. The emotional component of the mental process overwhelms the rational. Mr. Market is most notably irrational when he is fearful. Fortunately for the emotionally detached observer, the terrible death throes of a bear market are more easily identified than the extended elation that marks the end of a great bull run. The emotional undercurrent in a bull market is less conspicuous, being relatively well hidden by a facade of good news and confident forecast.

Much can be learned about Mr. Market's state of mind by observing the behavior of mutual fund buyers. The majority, by numbers if not dollars, are novices with moderate-sized portfolios. Their ranks have swelled dramatically in recent years. It is estimated that over 40 million families own shares of mutual funds. With over \$10 bil-

lion a month, net of withdrawals, flowing into mutual funds, that giant army of predominantly smallish investors has become the mouse that roared. Because of this, the nature of the process by which they make their decisions, both as buyers and perhaps eventually as sellers, is becoming more and more pertinent.

Why have savers ventured out from the relative emotional and financial security of their neighborhood bank and banker? Ostensibly, they are in pursuit of higher returns. But why now? Haven't total returns from common stocks and bonds eclipsed for generations, and by a considerable margin, those from savings accounts? Why not 15 years ago when stocks were fundamentally much cheaper? Sure but subtle changes in the distribution channels for financial services have played a big part. Advances in data processing, coupled with sponsors' aversion to defined benefit plans, have put fund-administered 401(k) plans within the reach of the employees of even the smallest companies.

Less conspicuous still are those evolutionary changes that have blurred the distinction between savings and investment. The information age and its by-product, a paperless money and banking system, and the merging roles of banker and broker have helped pave the way. Remember when a bank, with its marble and granite and massive walk-in safe, was the symbol of financial security and safety? Your three-piece suited banker was as permanent a community fixture as the heavy desk behind which he held court. Money was not so mobile then and the bank, in gratitude for regulated low savings rates and a loyal deposit base, dutifully recycled deposits as consumer and business loans and showered the community with its favors. It became the epicenter of financial, business, and civic life.

No longer does your bank and your banker symbolize all that they have in the past. Consolidation in banking has irrevocably altered their image. The sanctity of the banking franchise itself fell victim to the information age. My banker friends would have liked to continue doing business the old way but technology said "no." Gone is the name of your neighborhood bank and probably your banker. If bankers had known the extent of the revolution, they would have installed electronic signs so that names could be changed by a few strokes on a keyboard. Today much of banking is done electronically — by telephone, automated teller or computer. The consumer loan is in part supplanted by the ubiquitous and faceless credit card. And the savings account...

A watershed event took place in the early 1980's. Thanks to outdated regulations, securities brokers created a product that gave rise to a massive exodus of savers from banks. The money market fund siphoned hundreds of billions of dollars off to the asset-hungry brokerage firms. Instead of visiting their bankers with passbook in hand, savers called their brokers. Money market funds, with higher yields, came to be accepted as savings and checking account substitutes. Important differences were overlooked as the new idea took root. In time, banks were able to offer their own money market accounts, which further legitimized the product and promoted its acceptance.

Already comfortable with the broker and his ways of doing business, the saver's ascension to investor was made almost seamless. The bond or stock mutual fund became a natural product extension for the marketers of money market mutual funds. The proliferation of mutual funds is without precedent. Because of the similarity in form, the distinction in substance was conveniently blurred. Asked why he purchased the growth fund by liquidating part of his money market fund, the saver-turned-neophyte-investor is likely to reply, "to earn a higher return, stupid." And why does he think that common stocks will serve him better? "Look what they have done over the last 10 years." If only it were that simple. A little knowledge unchecked by healthy skepticism and encouraged by emotions that don't include fear can lead to acute disappointment. Is it any wonder why so many mutual fund investors left the table chastened in the years following the 1973-74 debacle. Even the great game of investment poker has its patsy. The weak link in the decision tree? It is not the fund manager who picks the stocks but the man-on-the-street fund investor who, in the aggregate, indirectly decides when he will buy (and sell) them.

Going up against a powerful adversary is difficult at best, calling upon all of your resources. The sheer size and power of Mr. Market is intimidating, making it sometimes difficult to stay focused on the fact that he is often both impulsive and irrational. He can be outsmarted by those who know his weaknesses and have the confidence and conviction to face him alone. Sometimes Mr. Market is difficult to identify. If your sage investment advice makes you the center of conversation at the golf course or at the

cocktail party, you have only to look in the mirror to find him! Emotional times call for rational minds.

Two metaphors help to make the point. When David faced Goliath it was David's ability to keep his emotions from ruling his rational mind and his awareness therefore that the giant's relative size conferred an arrogance that his intellect couldn't support, that gave David the edge and the ultimate victory. Lest we get too smug, though, there is also the story of General Custer. He began his career by graduating at the bottom of his class at the U.S. Military Academy. He won fame as a fearless cavalry leader. A glory seeker, it was high emotion and not clear thinking that had served him. Tragically, the Battle of Little Bighorn, because of the way Custer fought it, was about brawn and not brain. Custer's regiment of 650 was no match in a man-to-man showdown with the largest gathering of hostile tribes in Western history. On a scouting expedition several days before the battle, Custer estimated the enemy to be 1,000 strong after viewing by telescope their camp 15 miles away. In point of sad fact, there were 2,500 to 5,000. When a size mismatch is apparent, brute strength is rarely the sound response for the smaller combatant. Knowing your adversary, capitalizing on his weaknesses, including unchecked emotions  $\frac{3}{4}$  effectively using the sagacity of your rational mind to your benefit are the only true advantages you possess.

Frank K. Martin, CFA  
*Managing Partner*

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**CAPITAL MANAGEMENT, LLP**

Registered Investment Advisor

301B South Main Street / Suite 302 / P.O. Box 1288 / Elkhart, IN 46515 / Ph: 219.293.2077