

perspective

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Why Do Smart People Do Dumb Things?

After giving a patient a complete physical, a doctor explained his prescription as he wrote it down. "Take the green pill with a glass of water when you get up. Take the blue pill with a glass of water after lunch. When you retire for the evening, take the red pill with another glass of water." "What precisely is my problem, doctor?" the patient asked. "You are not drinking enough water," he explained.

Much of the commentary we read or hear on equity investing these days is preoccupied with the obvious, the colored pills, and not the nearly invisible water. While there seems to be widespread agreement that valuations are on the high side, explanations for the market's continued defiance of gravity are as varied as the colors of pills on which the patient is expected to focus their attention. That it is selling at three standard deviations or more from historical averages in ratios of price/earnings, price/book value, and price/dividend seems to be of no consequence. Among the more popular explanations for the suppression of gravity's law is that earnings growth, levitating well above the long-term trend line, will resume its salubrious course after the current pause, rising again thereafter indefinitely.

Maybe a clue to what is going on can be found by looking elsewhere than to the obvious. Warren Buffett was the guest on Adam Smith's Public Television Show "Face to Face" soon after the May 4th Berkshire Hathaway annual meeting. During the course of the interview Smith asked Buffett the following question: "Why do smart people do dumb things?" Buffett observed that both in investing and managing businesses there is a poor

correlation between IQ and results. According to Buffett, people who do well on IQ tests, who can play an excellent game of chess, clearly have the capacity to achieve. Yet something interferes with their ability to fully utilize that capacity. He suggested that the failure to think rationally is often the missing link for those unable to translate intellectual capacity to equivalent output. What interferes with rationality? States Buffett: "Ego, greed, envy, fear, mindless imitation of other people, and the fact that many smart people can't stand inaction" are among those factors that interfere with the efficient functioning of what otherwise is a rational mind. Buffett credits rational thinking more than IQ for the success that he and Charlie Munger have enjoyed: "You have to insulate yourself from the emotions running around you. That is hard for people to do."

Buffett, of course, is a master at independent thinking and action. If he ever is inclined to doubt the importance of insulating oneself from surrounding emotions, he need only look at his own investment record for reassurance. Most participants in the capital markets are not so equipped. Let's take Buffett's explanation a little farther for why smart people do dumb things, in part to help those who feel the need to reason through the hypothesis themselves.

By a way of introduction, we are aware that most modern economic models are constructed on the presumably solid bedrock of the rational-man hypothesis. After all, if man were deemed to behave otherwise, to what constructive use could these systematic attempts to divine the future possibly be put? If key model inputs were thought to be heavily influenced by extraneous factors rather than orderly thought, the predictive power of the popular forecasting constructs would be greatly diminished. Perhaps the sup-

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position that man is a reasonable creature was concocted by model builders desperate for improved forecasting results — not unlike the anthropological debate about whether God created man because he was lonely or man created God to bring order and purpose to the apparent chaos of life. I suspect that most readers would agree with the following assertion: The vast majority of people with whom we interact at work or leisure are neither wholly rational nor utterly specious. Models therefore work to some degree, but almost never to perfection.

The departure of domestic stock markets from time-tested models has inspired much conjecture by men and women of all economic and financial persuasions and biases. Their arguments run the gamut from new-era liberation to the dread of old eras forgotten. Reasonable analysts are searching for new models that explain these most unusual of times — if, of course, history will choose to record them as such. The rational-man hypothesis appears to fall somewhat short of explaining this seemingly endless wave of euphoria that the chairman of the Federal Reserve Board dubbed 18 months and 2,500 Dow points ago as one of “irrational exuberance.”

Sometimes, as Buffett suggests, human beings are not entirely rational in their behaviors. Perhaps there is explanation beyond the emotions of fear and greed, among others, to which Buffett alluded. Could the explanation be found in a behavioral propensity so subtle, so subliminal, as to virtually escape notice — not unlike the pills-and-water example? Perhaps there are forces at work that provoke irrational behaviors that are even more pervasive than Buffett's observations would suggest. If what we now argue is pertinent, then it makes a far more compelling and ominous case for an inexorable pattern of collective irrationality that eventually evolves into a full-blown mania.

Confirmation that humankind has not evolved to a supremely civilized and rational state is as close

as the evening paper. But, it is said, in matters of the economic realm the human being is prone to act in a more logical manner. A trip through the supermarket should provide evidence of humanity at our rational best. A post-checkout survey of sample grocery carts' contents may lead one to a different conclusion. Tucked away among the cartons of milk and loaves of bread one might find presumed nonessentials ranging from the *National Enquirer* to a box of Twinkies. Impulsiveness, spontaneous or subliminally stimulated, is common in even the most basic and routine of economic endeavors.

Although Buffett's explanation for an individual's aberrant behavior is eminently plausible, let's look at man's penchant for quirky behavior from an entirely different perspective. A body of thought postulating that man undergoes a discernible behavioral transformation when he becomes part of a group has intrigued us for years. The idea is as intuitively appealing as it is resistant to scientific verification. Anecdotal evidence abounds, including the rise of Nazi Germany in the 1930s, but systematically profiling the psychology of a crowd using techniques common to the study of individuals is a practical impossibility. What we hope to accomplish, with the help of some giants in the field of human behavior (and a bit of supposition on our part), is to attempt to make sense out of a perplexing behavioral dichotomy: How can intelligent, rational individuals occasionally act as “blockheads”? (This is Bernard Baruch's choice of choice words, not ours, quoting from Schiller's dictum in the foreword to the behavioral-sciences classic *Extraordinary Popular Delusions and the Madness of Crowds*.) Such knowledge may be of great utility in the activity of immediate interest to us, that of investment decision-making.

Part of the attractiveness of the theory, beyond its presumed commercial application, is that it assiduously avoids assaulting the superior rationality of the individual who is thinking and acting in a state of isolation. No reader in control of his faculties should feel threatened or insulted. It

allows, however, for the possible sublimation of those higher-order aptitudes when an individual willingly or unconsciously surrenders his intellectual independence to the capriciousness of the crowd. Using an extreme example, have you ever wondered why angry mobs and not solitary individuals carry out lynchings? What causes an otherwise moral person, when in the company of others, to temporarily submit to barbaric impulses?

Moral Man and Immoral Society, by theologian Reinhold Niebuhr, alludes to the paradox in the province of moral conduct. Frenchman Gustave Le Bon, in his groundbreaking social-psychology masterpiece *The Crowd*, first published in 1895, hypothesized that people functioning in groups undergo profound changes as a direct result of collective decision-making. One hundred years later Le Bon's insights constitute the intellectual underpinnings of an uncommon explanation for episodes of irrationality in the financial markets. If we are thus able to communicate what we hope you will come to accept as humankind's capacity for collective delusion, we shall all have the intellectual armor necessary to protect ourselves against its assault upon our subconscious.

Making the subject even more relevant today is the ease by which a crowd, as Le Bon defines it, may take form, thanks to a communications infrastructure unimaginable in his time. Thus a group, however geographically diverse, may exhibit the same characteristics as the physically homogeneous crowd of yesteryear, as portrayed most effectively in the recently popular movie *Braveheart*.

Even if we can agree on what constitutes a crowd, unanimity concerning its provisional psychological characteristics may be more difficult to achieve. Since we have no means to prove the point scientifically, we ask only that you apply the ideas in the examination of crowds with which you are familiar to see if they make

innate sense. For example, one might apply what is postulated here to the upcoming congressional political campaigns.

First of all, the personality of a crowd is not fixed. It varies in its nature and intensity according to the causes that brought about and perpetuated its existence. The characteristics attributable to collective thinking and behavior, to which these comments attend, are most noticeable when a crowd has reached a fully organized state.

Le Bon, and later Freud, recognized the impact of the subconscious on human behavior. The unconscious elements, those that embody the "genius of a race," are the characteristics that cause individuals belonging to it to resemble each other. The conscious elements in our makeup — education, occupation, social status, and exceptional hereditary factors — are where individuals differ. Despite the dissimilarities of the observable, "Men the most unlike in the matter of their intelligence possess instincts, passions, and feelings that are very similar. In the case of everything that belongs to the realm of sentiment — religion, politics, morality, the affections and antipathies, etc. — the most eminent men seldom surpass the standard of the most ordinary." So says Le Bon. It is those very attributes that in crowds become common property.

The fact that crowds are limited in cerebral functioning to the use of those capacities common to all explains why they are intellectually inferior to the isolated individual. We readily acknowledge that, by virtue of a crowd's reliance on instinct rather than reason, the power and energy it possesses is capable of being harnessed to accomplish selfless acts of heroic proportions, before which solitary individuals would cower in fear. The movie *Braveheart*, to which we just referred, was a powerful example of the force of a crowd channeled to defeat the army of the King of England. William Wallace, a su-

perb leader (and apparent student of crowd psychology!), orchestrated this predisposition for the good of Scotland. Le Bon again: "The decisions affecting matters of general interest come to be by an assembly of men of distinction, but specialists in different walks of life, are not sensibly superior to the decisions that would be adopted by a gathering of imbeciles." These are strong words to be sure. Do not be put off. They are from the pen of a man who occasionally turned to hyperbole to emphasize a point. Even watered down, they provide sometimes-painful insight into certain tendencies of group structures, such as committees, of which we all likely are aware. In algebra, if an analogy might be offered, no solution is possible until every fraction is reduced to the "lowest common denominator."

Television, the marvel that brought the world into our family room, has had many unintended consequences. The prospect of a better-informed electorate was neutralized when television, which overwhelms our senses, robbed us of much of our capacity for reason, transfixing those who sit before it into a servile crowd. The positioning of political candidates this fall will be most effective when the handlers package their aspirants accordingly. Exaggeration, affirmation, and repetition, as you may well have observed, move a crowd, not reason.

An individual who forms part of a crowd acquires, by virtue of its size and the power thus conferred, a feeling of invincibility that enables him to yield to instincts which, were he alone, he would keep under control. A crowd is by definition anonymous and therefore its members feel little obligation (unlike if they were solely accountable) to own up to their behavior. Also, the difficult-to-explain phenomenon known as contagion, perhaps likened to hypnosis, leads individuals to blithely sacrifice their

personal interest to the vagaries of collective interest. A person who is one with a crowd is also highly susceptible to suggestion, often undertaking the accomplishment of acts with "irresistible impetuosity." This tendency itself is exacerbated by reciprocity and lubricated by a kind of unctuous smugness.

Crowds, deprived of the critical faculty of systematic thinking, are at the mercy of external stimuli that frequently provoke impulsive responses. Accordingly, the sentiments of crowds are as mobile as the forces that excite them. They are as frenzied as they are transitory. It does not require an intellectual leap to appreciate that crowds are excessively credulous. The impossible does not exist for a crowd. It scarcely distinguishes between the subjective and the objective. It accepts as real the images evoked in its collective mind, irrespective of how close they may be to observable fact. A crowd is thus capable of collective hallucination.

There is so much more to be said about the metamorphosis that occurs when groupthink, an oxymoron to the social psychologist, overrides the superior intellectual capacity of the individual. Let us conclude by challenging the reader to apply the theory of the crowd as espoused above to the goings-on in the capital markets of late. What may seem incomprehensible to the informed individual who beholds the phenomenon from his own rational perspective becomes more believable when viewed through the prism of an amalgamation of people who comprise a crowd. The extremes to which such gatherings are capable of going — because of their innate, almost sub-human proclivities — are manifestly obvious today.

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