THE EMOTIONAL INVESTOR

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An Investing Lesson from a Turkey

How do investors that are looking to improve their investment techniques and skills obtain that information? Who do they go to? Warren Buffet? An investment newsletter? CNBC? I seriously doubt any of you thought of a turkey (unless you looked at the title). That is right, the delicious Thanksgiving meal can teach us a very important lesson about how we think about our present and future investments.

Nassim Taleb, author of The Black Swan[i], analyzed a turkey's behavior and thought process, calling his observation "The Turkey Fallacy". In this analogy, a turkey receives food each day of his life. This is viewed as evidence that his major role in life is to be fed every day. And each day the turkey is fed, the belief is further confirmed. This pattern continues for some time until the day before Thanksgiving. It is then that the turkey has a change in his belief, but it is too late.

We also tend to project past occurrences into beliefs about the future. It is common for investors to view past performance and automatically believe that type of performance will continue in the future, whether it is good or bad. And this happens not only with investors, but also with "experts" that we supposed to listen to. And it isn't really our fault.

Our brain is constructed in a way that it searches for patterns. Neuroscientists have found that our brain detects a pattern once we see the same event occur two times in a row…and that this detection is subconscious. So upon viewing a fund that performed well the last few years, our brain will "recognize" a pattern and extrapolate it into the future, without us even realizing it. So while the disclaimer says "Past performance is no guarantee of future results", our brain is telling us to go ahead and assume it will continue.

EFFECT ON EXPERTS

Economists, security analysts and other professionals frequently provide forecasts on the economic future and outlook for stock and bond values. But how good are their forecasts? A study of 2,000 past economic predictions found that economists didn't predict anything – their predication was just an extrapolation of prior data.[ii] It is important to understand the propensity for forecasters to look to the past as a guide for their current forecast.

EFFECT ON INVESTORS

In 2000, after years of significant market gains, many investors expected the gains to continue. Analysts and other experts forecasted banner growth rates going forward. Investors reacted by shifting assets into stocks in expectation for future gains. Both investors and experts looked to the past to guide their decisions for the future. It was a costly mistake.

Fast forward to the stock market bottom in early 2009. Investors had just lived through a major financial crisis, resulting in significant market losses. Analysts and experts had lowered their financial forecasts. In response, many investors sold stocks as the market bottomed and missed a significant rally. Poor market performance, coupled with unreliable expert forecasts, led many investors to project past occurrences into the future. Another costly mistake.

WHAT YOU CAN DO ABOUT IT

1) Recognize that the brain is constantly looking for patterns and may identify "patterns" without you knowing. Security returns are random, but they may appear to the brain to have a pattern in the short term.

2) Understand that financial experts are subject to the very same problem and that they aren't good at *correctly* forecasting the future

3) Investment decisions should be based upon a sound strategy of diversification and philosophy, not past performance. Security performance is mostly random, and prior random results should not influence your future investment decisions.

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[i] Taleb, Nassim N. (2007). *The Black Swan: The Impact of the Highly Improbable*, New York, Random House.
[ii] Bouchaud, J.P., & Potters, M. (2003). *Theory of financial risks and derivatives pricing: from statistical physics to risk management*. 2nd ed. Cambridge, MA: Cambridge University Press