Math, History and Psychology - Part 3

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Dear Fellow Investors:

Over the years, we have heard Charlie Munger state that Psychology is the most underrated and underutilized of the major academic disciplines in business and investing. Andy Grove backed this up in a Fortune magazine interview by telling about the best business advice he had ever received. His City College of New York professor told him, “When everybody knows that something is so, it means nobody knows nothin’.” At Smead Capital Management (SCM), we like to say that successful investing is the defeat of human nature. This missive will dig into the academic discipline of psychology and speak to using it to invest successfully.

Why is psychology an underrated and under-utilized discipline in business? We believe there are four reasons. First, it is counter-intuitive. Psychology requires you to toss out logic and rationality. When there are either seemingly unsolvable economic or business problems, psychology demands at the extreme that you bet against the obvious. When a never ending stream of good news causes logical and rational experts to predict more of the same, you must “circle the wagons” (John Kenneth Galbraith-A Short History of Financial Euphoria). Currently, the US stock market suffers from what Randall Forsyth at Barron’s calls “rational despair”. It is an unhealthy pessimism in the same way that ‘irrational exuberance” was a destructive optimism. These are psychological phenomena.

Second, psychology never got the best scholars or professors. In the late 1970’s, psychology was considered an easy class and a default major for those on rehab from economics or math or history or chemistry. Psychology has been considered somewhat of a “voodoo” discipline. It helps us explain things, but can it really solve anyone’s problems. Psychology is the unwanted step-child of higher academics.

Third, psychology kills the ability of intelligence to equate to successful investing. A PhD in Economics or Math and a librarian are likely to know math and history better than anyone you know. However, the math you need to be a successful investor is learned by the end of the seventh grade, in our opinion. If you are comfortable doing percentages and have the ability to understand crowd psychology, you can be a wealth creator in the US stock market. Over-educated people have a tendency to over think situations. Ben Graham said that as soon as the complex math gets thrown into the situation, you know that trouble is brewing. Here is how he said it in 1958:

"Mathematics is ordinarily considered as producing precise, dependable results. But in the stock market, the more elaborate and obtuse the mathematics, the more uncertain and speculative the conclusions we draw there from. Whenever calculus is brought in, or higher algebra, you can take it as a warning signal that the operator is trying to substitute theory for experience."

Just ask the folks at Long-Term Capital Management or analyze the investment returns of all the money being run today based on macroeconomic/mathematical genius in mutual funds, ETFs and hedge funds. Is the average institutional investor getting what they are paying for? Is there any chance the category is going to do well when it reaches down into the retail investment world? It is one of the psychological signs that we look for.

Lastly, psychology is hard to measure. At SCM, we look at sentiment polls, insider buying, media coverage, asset allocation, anecdotal evidence and just about anything else which confirms that the crowd has moved to one side of a market. Reading the psychology is mostly learned by participating in the markets and through years of experience. The primary benefit of experience is having been in similar situations before. Professional golfers talk about dealing with the psychology of being the leader on Sunday in a pro golf tourney. Professional investors measure psychology in the same way. It is a gut feel and a learned discipline.

Andy Grove's thought points out that psychology in business is most valuable at extremes. At SCM, we operate under the assumption that if 80% of the participants in a market are bullish or bearish, the exact opposite of their opinion is the right bet. A few examples would be helpful. Everyone knew by 1999 that the internet was "going to change our life" and that you must own companies which would benefit from that huge secular trend. They couldn't have been more wrong. The sentiment polls showed historically high levels of bullishness among individual and institutional investors. A Paine Webber/Gallup poll of their clients with less than five years experience showed that they expected 22.6% compounded returns over the next ten years. They got two 40% bear market declines and a lost decade in the stock market.

A Bespoke website poll at the bottom of the stock market on March 9th of 2009 showed that 89% of those polled felt that the US stock market was headed lower and 59% felt that it would bottom at or below 5000 on the Dow. It was trading at 6480 at the time. One year ago, the Barron's "Big Money Poll" showed that 73% of those polled were bearish on US Treasury Bonds and only 5% were bullish. The tiny minority was the big winner over one year. At the risk of being repetitive, psychology is very useful at extremes.

This same psychology is useful in the shares of individual common stocks. We have a rule at SCM. Whatever we own that gets questioned, objected to or made fun of by those we come in contact with, is likely to outperform in the following three years. In 2008, we got a regular diet of criticism for owning Starbucks (SBUX). Every day, someone would call us and say, "Nobody is going to want to pay $4 for a cup of coffee" or "those guys will never get their mojo back".

We've received the most questions recently on Bank of America (BAC) and Gannett (GCI). Quite a contrast, since Warren Buffett seems to be buying up every community newspaper in the country and pumped $5 billion into Bank of America preferred stock with warrants to buy the common attached. We have been questioned for avoiding energy, basic material and heavy industrial shares in light of the secular crowd belief in the "global synchronized trade". China's secular trend smells, feels and acts like the internet bubble to us, so we have to sit it out.

In summary, we at SCM believe that the academic disciplines of Math, History and Psychology are important to undergirding the investment discipline of those who seek to create wealth in common stock investing. All three in concert is our preference and don't forget to pay psychology its proper respect.

Best Wishes,

William Smead

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