

Selected Published Columns on Investor Irrationality (Behavioral Finance)

By Whitney Tilson

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7. **Munger Goes Mental** (6/4/04). Charlie Munger, the famed right-hand man of Warren Buffett, gave a brilliant speech last October at the University of California, Santa Barbara. With Munger's permission, I published a transcript for the first time and shared the highlights in this column.
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Investors as Pecking Pigeons

Whitney Tilson shares some lessons from his trip to Italy, plus two studies that provide insight into investor irrationality.

By [Whitney Tilson](#)

Published on the Motley Fool web site, 6/18/04

(www.fool.com/news/commentary/2004/commentary040618wt.htm)

Greetings from Molfetta, Italy! Before I get to the main topic of today's column, allow me to tell you about this coastal region on the Adriatic and why I'm here.

I'm spending a week in this town in the southeastern part of the country vacationing with my family and teaching a seminar on value investing. This region of Italy, called Puglia, produces most of the country's olive oil and pasta and has a fascinating, ancient history -- we've visited gorgeous castles and cathedrals that are nearly 1,000 years old. And if you're looking to get off the beaten path, this is it. We have yet to encounter other Americans. While I highly recommend Rome, Florence, and Venice, running into busloads of tourists every five minutes gets old.

Our host is Francesco Azzollini, who has established a value-oriented investment fund here -- the first in Italy, he believes. He taught himself investing by reading all of the classics and sitting in on classes taught at Columbia Business School. He's been applying those lessons with a great deal of success, compounding money at 18% since the fund's inception in 2000. He invests primarily in the same situations as U.S.-based value investors: out-of-favor companies, stubs, post-bankruptcies, etc., that trade on the American stock exchanges (though, not surprisingly, he also dabbles in Europe). It's fascinating and heartening to see that the gospel of Graham, Dodd, Buffett, and Munger has reached this remote corner of Italy.

Francesco's success underscores two important points about value investing. First, one can become a skilled practitioner of the craft without following the typical route of getting an MBA and then apprenticing at a fund. In fact, given how poorly investing is taught at most business schools and practiced at most funds, one might be better off *without* these experiences!

Second, the importance of having access to company managements and making site visits is way overblown. In fact, this too can work against an investor's interests. (There's an unfortunate amount of truth to the joke about how can you tell when a CEO is lying? His lips are moving.) Through the Internet, Francesco can access all of the information he needs to make informed decisions, and his remote location isolates him from the sound and fury (read: nonsense) of Wall Street. You can be sure that CNBC (Bubblevision) isn't blaring in his office, and since the U.S. market doesn't open until 3:30 in the afternoon here, he has nearly the entire day to read and do analysis. Hmmm... Maybe I'll just stay here...

Investor irrationality

Back to our regularly scheduled programming...

I've long believed that investment success requires far more than intelligence, good analytical abilities, proprietary sources of information, and so forth. Equally important is the ability to overcome the natural human tendencies to be extremely irrational when it comes to money. Warren Buffett agrees, commenting that, "Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ... Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

Investing for the birds

With this in mind, let's examine an experiment done with pigeons that I think provides insight into the bizarre investment behavior I observed in my January column, [A Scary Time for Stocks](#): "It's mind boggling that so many investors are piling back into the same sectors that crushed them only a short time ago, like moths drawn to a flame." My lament prompted my friend Peter Kaufman, a board member of **Wesco Financial** ([NYSE: WSC](#)), to email me the following:

Your observation made me think of classic behavioral research of the 1950s, which employed rats or pigeons to determine how thinking creatures react to certain situations. One such research project, "Pigeons at a Feeding Bar," may offer some insight into this "moth-like" tendency of investors to return again and again to the same bad situation.

In one stage of the research project, pigeons are first acclimated to a set pattern of food rewards, in which the pigeon "earns" his kernels by pecking a feeding bar until a unit of food is delivered (for example, the pattern might be for one kernel after every 10 strikes of the bar). Subsequent to this particular pattern being established, food delivery is terminated altogether, allowing researchers to tabulate how long a pigeon will continue to hit the feeding bar before it realizes it has become fruitless to do so. The research revealed that pigeons are, as a group, remarkably consistent in the time that elapses until they realize that a formerly productive pattern has been replaced by a new, fruitless one. Once pigeons rationally discern the true pattern, they uniformly abandon the process in a predictable and timely manner.

But what happens if no true pattern of reward ever exists in the first place? For example, what happens if instead of an established pattern of rewards, the feeding bar reward sequence is purely arbitrary (i.e. a random number table is used to set reward intervals)? Under this scenario, the poor pigeons encounter a mind-spinning quandary: Although they see there are alluring rewards to be had in the system, they are unable to grasp how those rewards can be consistently earned. The amazing result: In random-number versions of this experiment, even after the food delivery has been terminated altogether, pigeons return again and again, relentlessly hitting the bar until finally they drop from physical exhaustion.

What relevance do pigeon studies of the 1950s have to Wall Street behavior in 2004? Well, at the risk of overdrawing animal behavior to human behavior, investors repeatedly returning "to the flame" sure looks a lot like the behavior of lab pigeons in the second version of the experiment. And the reason appears to be the same: Both the investors and the pigeons are mesmerized by the tasty rewards they believe lie within the system, and both are similarly unable to divine a recognizable pattern as to how such rewards are

earned at the feeding bar.

Should investors' inability to grasp a recognizable pattern really surprise us? Investors have watched in bewilderment as an entire investment hierarchy has thrown out basic accounting conventions and valuation metrics that have been in effect for nearly a century; they have seen initial public offerings soar to the stratosphere for companies with no comprehensible business model, no cash flow, and sometimes, even no revenue; and they continue to see CEOs drive their companies into the ground while nevertheless receiving tens or hundreds of millions of dollars of stock options. Is it any wonder why investors are unable to identify a recognizable, dependable pattern as to how rewards are to be earned in this system?

Researchers learned that pigeons, faced with alluring rewards but without recognized patterns as to how they are earned, essentially go mad, incessantly returning to hit the bar until they physically collapse. Sadly, in environments such as market bubbles, it seems this same stimulus-response mechanism can apply to human beings. Just as is the case with slot machines, lotteries and other forms of unskilled gambling, when investment returns take on the character of being arbitrary, unearned, or random, human hope springs eternal -- rendering many investors unable to resist the feeding bar.

Can anything be done to stop this recurring insanity? As the lab pigeons showed us, the only real antidote for irrational investor behavior, is rationality (i.e. the ability to truly understand what is going on). In other words, the antidote for market bubbles is rational pattern recognition, recognizing that the valuations of the securities they are snapping up have no basis in future earning power or any other objective economic measure, but instead have a basis in grossly unrealistic claims, promotions, hopes, and dreams.

Is there any hope that the irrational exuberance bemoaned by Alan Greenspan in December of 1996 will evolve into a saner set of investor behaviors? I'm not holding my breath. Human greed and wishful thinking, time tested as they are, suggest that most human investors will never be anything but pigeons.

Translating theory to practice

I think my friend is exactly right, and his conclusions are supported by other studies conducted by Vernon Smith, a professor at George Mason University who shared in the 2002 Nobel Prize for economics. As described in *The Wall Street Journal* on April 30, in numerous experiments he conducted, "participants would trade a dividend-paying stock whose value was clearly laid out for them. Invariably, a bubble would form, with the stock later crashing down to its fundamental value." One would think that the participants, having suffered horrible losses, would have learned not to speculate. Yet when they gathered for a second session, "still, the stock would exceed its assigned fundamental value, though the bubble would form faster and burst sooner."

How could another bubble form so quickly? Simple: The take-away lesson investors learned the first time was not "don't speculate," but rather, "it's OK to speculate, but one must sell more quickly once the bubble starts to burst." Sound familiar?

Of course this game doesn't work either, since few people can accurately time the top and everyone tends to head for the exit at the same time. Professor Smith notes that "The subjects are very optimistic that they'll be able to smell the turning point" and "They always report that they're surprised by how quickly it turns and how hard it is to get out at anything like a favorable price."

Thus, it is only when Professor Smith runs the session a third time that "the stock trades near its fundamental value, if it trades at all."

I would argue that in many sectors, we are in the midst of the second mini-bubble and that speculators will be crushed again. Investors -- and pigeons -- beware!

Contributor Whitney Tilson is a longtime guest columnist for The Motley Fool. He owned shares of Berkshire Hathaway at press time, though positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your [feedback](#). To read his previous columns for The Motley Fool and other writings, visit <http://www.tilsonfunds.com>. The Motley Fool is [investors writing for investors](#).

The Perils of Investor Overconfidence

By Whitney Tilson (Tilson@Tilsonfunds.com)

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(<http://www.fool.com/BoringPort/1999/BoringPort990920.htm>)

NEW YORK, NY (September 20, 1999) -- Hello, fellow Fools. Dale is away this week and he invited me to be a guest columnist today, Wednesday, and Friday in his absence.

First, by way of introduction, when I began investing a few years ago, I tried to educate myself by reading everything I could find on the topic (click [here](#) for a list of my all-time favorite books on investing). Being an early user of the Internet, I soon discovered The Motley Fool, which I have enjoyed and learned from immensely.

The topic I'd like to discuss today is behavioral finance, which examines how people's emotions affect their investment decisions and performance. This area has critical implications for investing; in fact, I believe it is far more important in determining investment success (or lack thereof) than an investor's intellect. Warren Buffett agrees: "Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

Numerous studies have shown that human beings are extraordinarily irrational about money. There are many explanations why, but the one I tend to give the most weight to is that humans just aren't "wired" properly. After all, *homo sapiens* have existed for approximately two million years, and those that survived tended to be the ones that evidenced herding behavior and fled at the first signs of danger -- characteristics that do not lend themselves well to successful investing. In contrast, modern finance theory and capital markets have existed for only 40 years or so. Placing human history on a 24-hour scale, that's less than two seconds. What have you learned in the past two seconds?

People make dozens of common mistakes, including:

- 1) Herding behavior, driven by a desire to be part of the crowd or an assumption that the crowd is omniscient;
- 2) Using mental accounting to treat some money (such as gambling winnings or an unexpected bonus) differently than other money;
- 3) Excessive aversion to loss;
- 4) Fear of change, resulting in an excessive bias for the status quo;
- 5) Fear of making an incorrect decision and feeling stupid;
- 6) Failing to act due to an abundance of attractive options;
- 7) Ignoring important data points and focusing excessively on less important ones;
- 8) "Anchoring" on irrelevant data;
- 9) Overestimating the likelihood of certain events based on very memorable data or experiences;
- 10) After finding out whether or not an event occurred, overestimating the degree to which they would have predicted the correct outcome;
- 11) Allowing an overabundance of short-term information to cloud long-term judgments;

- 12) Drawing conclusions from a limited sample size;
- 13) Reluctance to admit mistakes;
- 14) Believing that their investment success is due to their wisdom rather than a rising market;
- 15) Failing to accurately assess their investment time horizon;
- 16) A tendency to seek only information that confirms their opinions or decisions;
- 17) Failing to recognize the large cumulative impact of small amounts over time;
- 18) Forgetting the powerful tendency of regression to the mean;
- 19) Confusing familiarity with knowledge;
- 20) Overconfidence

Have you ever been guilty of any of these? I doubt anyone hasn't.

This is a vast topic, so for now I will focus on overconfidence. In general, an abundance of confidence is a wonderful thing. It gives us higher motivation, persistence, energy and optimism, and can allow us to accomplish things that we otherwise might not have even undertaken. Confidence also contributes a great deal to happiness. As one author writes (in an example that resonated with me, given the age of my daughters), "Who wants to read their children a bedtime story whose main character is a train that says, 'I doubt I can, I doubt I can'?"

But humans are not just robustly confident—they are wildly overconfident. Consider the following:

- 82% of people say they are in the top 30% of safe drivers;
- 86% of my Harvard Business School classmates say they are better looking than their classmates (would you expect anything less from Harvard graduates?);
- 68% of lawyers in civil cases believe that their side will prevail;
- Doctors consistently overestimate their ability to detect certain diseases (think about this one the next time you're wondering whether to get a second opinion);
- 81% of new business owners think their business has at least a 70% chance of success, but only 39% think any business like theirs would be likely to succeed;
- Graduate students were asked to estimate the time it would take them to finish their thesis under three scenarios: best case, expected, and worst case. The average guesses were 27.4 days, 33.9 days, and 48.6 days, respectively. The actual average turned out to be 55.5 days.
- Mutual fund managers, analysts, and business executives at a conference were asked to write down how much money they would have at retirement and how much the average person in the room would have. The average figures were \$5 million and \$2.6 million, respectively. The professor who asked the question said that, regardless of the audience, the ratio is always approximately 2:1.

Importantly, it turns out that the more difficult the question/task (such as predicting the future of a company or the price of a stock), the greater the degree of overconfidence. And professional investors -- so-called "experts" -- are generally even more prone to overconfidence than novices because they have theories and models that they tend to overweight.

Perhaps more surprising than the degree of overconfidence itself is that overconfidence doesn't seem to decline over time. After all, one would think that experience would lead people to

become more realistic about their capabilities, especially in an area such as investing, where results can be calculated precisely. Part of the explanation is that people often forget failures and, even if they don't, tend to focus primarily on the future, not the past. But the main reason is that people generally remember failures very differently from successes. Successes were due to one's own wisdom and ability, while failures were due to forces beyond one's control. Thus, people believe that with a little better luck or fine-tuning, the outcome will be much better next time.

You might be saying to yourself, "Ah, those silly, overconfident people. Good thing I'm not that way." Let's see. Quick! How do you pronounce the capital of Kentucky: "Loo-ee-ville" or "Loo-iss-ville"? Now, how much would you bet that you know the correct answer to the question: \$5, \$50, or \$500? Here's another test: Give high and low estimates for the average weight of an empty Boeing 747 aircraft. Choose numbers far enough apart to be 90% certain that the true answer lies somewhere in between. Similarly, give a 90% confidence interval for the diameter of the moon. No cheating! Write down your answers and I'll come back to this in a moment.

So people are overconfident. So what? If healthy confidence is good, why isn't overconfidence better? In some areas -- say, being a world-class athlete -- overconfidence in fact might be beneficial. But when it comes to financial matters, it most certainly is not. Overconfidence often leads people to:

- 1) Be badly prepared for the future. For example, 83% of parents with children under 18 said that they have a financial plan and 75% expressed confidence about their long-term financial well being. Yet fewer than half of these people were saving for their children's education and fewer than 10% had financial plans that addressed basic issues such as investments, budgeting, insurance, savings, wills, etc.
- 2) Trade stocks excessively. In Odean and Barber's landmark [study](#) of 78,000 individual investors' accounts at a large discount brokerage from 1991-1996, the average annual turnover was 80% (slightly less than the 84% average for mutual funds). The least active quintile, with average annual turnover of 1%, had 17.5% annual returns, beating the S&P, which was up 16.9% annually during this period. But the most active 20% of investors, with average turnover of more than 9% monthly, had pre-tax returns of 10% annually. The authors of the study rightly conclude that "trading is hazardous to your wealth." Incidentally, I suspect that the number of hyperactive traders has increased dramatically, given the number of investors flocking to online brokerages. Odean and Barber have done another fascinating [study](#) showing that investors who switch to online trading suffer significantly lower returns. They conclude this study with another provocative quote: "Trigger-happy investors are prone to shooting themselves in the foot."
- 3) Believe they can be above-average stock pickers, when there is little evidence to support this belief. The study cited above showed that, after trading costs (but before taxes), the average investor underperformed the market by approximately two percentage points per year.
- 4) Believe they can pick mutual funds that will deliver superior future performance. The market-trailing performance of the average mutual fund is proof that most people fail in this endeavor. Worse yet, investors tend to trade in and out of mutual funds at the worst possible time as they chase performance. Consider that from 1984 through 1995, the average stock mutual fund posted

a yearly return of 12.3% (versus 15.4% for the S&P), yet the average investor in a stock mutual fund earned 6.3%. That means that over these 12 years, the average mutual fund investor would have made nearly twice as much money by simply buying and holding the average mutual fund, and nearly three times as much by buying and holding an S&P 500 index fund. Factoring in taxes would make the differences even more dramatic. Ouch!

5) Have insufficiently diversified investment portfolios.

Okay, I won't keep you in suspense any longer. The capital of Kentucky is Frankfort, not "Loo-ee-ville," an empty 747 weighs approximately 390,000 lbs., and the diameter of the moon is 2,160 miles. Most people would have lost \$500 on the first question, and at least one of their two guesses would have fallen outside the 90% confidence interval they established. In large studies when people are asked 10 such questions, 4-6 answers are consistently outside their 90% confidence intervals, instead of the expected one of 10. Why? Because people tend to go through the mental process of, for example, guessing the weight of a 747 and moving up and down from this figure to arrive at high and low estimates. But unless they work for Boeing, their initial guess is likely to be wildly off the mark, so the adjustments need to be much bolder. Sticking close to an initial, uninformed estimate reeks of overconfidence.

In tests like this, securities analysts and money managers are among the most overconfident. I'm not surprised, given my observation that people who go into this business tend to have a very high degree of confidence. Yet ironically, it is precisely the opposite -- a great deal of humility -- that is the key to investment success.

--Whitney Tilson

P.S. If you wish to read further on the topic of behavioral economics, I recommend the following (I have drawn on heavily on the first two in this column):

- [Why Smart People Make Big Money Mistakes](#), by Gary Belsky and Thomas Gilovich.
- "[What Have You Learned in the Past 2 Seconds?](#)," paper by Michael Mauboussin, CS First Boston.
- In May and June this year, David Gardner wrote four excellent columns in The Motley Fool's Rule Breaker Portfolio: [The Psychology of Investing](#), [What's My Anchor?](#), [Tails-Tails-Tails-Tails](#), and [The Rear-View Mirror](#).
- There's a great article about one of the leading scholars in the field of behavioral finance, Terrance Odean (whose [studies](#) I linked to above), in a recent issue of *U.S. News & World Report*: "[Accidental Economist](#)"
- [The Winner's Curse](#), by Richard Thaler.
- The [Undiscovered Managers](#) website has links to the writings of Odean and many other scholars in this area.

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Don't Chase Performance

Investors have an awful, unshakable habit of piling into the hottest investment fad at precisely the wrong time. Whitney Tilson argues that you shouldn't let the recent stock market turbulence scare you into switching your assets into bonds or housing, which offer a false illusion of safety.

By Whitney Tilson

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(<http://www.fool.com/news/foth/2002/foth021023.htm>)

If there's one thing as certain as death and taxes, it's that investors will chase performance, almost always to their detriment.

Consider the study from 1984 through 1995, which showed that while the average stock mutual fund posted a yearly return of 12.3% (versus 15.4% for the S&P 500), the average investor in a stock mutual fund earned only 6.3%. Put another way, over those 12 years, the average mutual fund investor would have ended up with nearly twice as much money by simply buying and holding the average mutual fund -- not to mention about 2.5 times as much by buying an S&P 500 index fund.

How can this be? Simple. Like moths to a flame, investors are invariably drawn to top-performing funds. They pile into them at their peaks, ride them down, and then repeat the process again and again. For a recent example of this phenomenon, consider the tens of billions of dollars investors put into Janus mutual funds in early 2000 -- money that has all but evaporated.

When it comes to mutual funds, past performance is indeed no predictor of future success. A study by the Financial Research Corp. of Boston found that from 1988 to 1998, the average performance of funds placing in the top 10% of their peer groups in one year almost invariably fell back toward the middle of the next year. In fact, the study found that, out of the 40 quarterly periods measured, only once did the average performance of the top 10% of funds place into even the top 25% in the subsequent year. (For more on this topic, I recommend a 1999 [article](#) by William Bernstein.)

So what should an investor do? Invest in the worst-performing funds? Nope, studies show that they do even worse. The answer is to find an investment manager with a sound investment strategy and a proven ability to carry it out (I shared my thoughts on this topic in [Traits of Successful Money Managers](#)). The mutual funds or fund families I suggest considering are (in no particular order): Longleaf (about which Zeke Ashton [recently wrote](#)), Clipper, Oakmark, Olstein, Third Avenue, and Tweedy Browne (I'd recommend the Sequoia Fund as well, but it's been closed to new investors since 1982). For further information, check out The Motley Fool's [Mutual Fund Center](#) and our [How to Pick the Best Mutual Funds](#).

Chasing performance is, of course, not limited to mutual funds. The same phenomenon is occurring, I believe, in the bond and housing markets today.

Bonds

As investors have fled stocks over the past two and a half years, they have sought safety in other areas to such an extent that bonds have outperformed stocks over the past five, 10, and 15 years. That's an amazing fact, given the unprecedented bull market that prevailed for most of the last two decades. Such outperformance by bonds is quite rare. According to statistics in Jeremy Siegel's [Stocks for the Long Run](#), from 1871 to 1996, stocks outperformed bonds in 72.1% of five-year periods, 82.1% of 10-year periods, and 94.4% of 20-year periods (there was no data on 15-year periods).

Though recently stocks have spiked up and bond yields have risen from multi-decade lows, I think it's very unlikely that bonds will continue to do better than stocks over the next five or more years. That's not to say I think stocks will be a great investment, but with the yield on the 10-year Treasury note a mere 4.26% (as of yesterday's close), the hurdle isn't very high. The legendary Bill Gross, manager of the largest bond fund in the world, Pimco Total Return Fund, disagrees (surprise!). He thinks the fair value for the stock market is Dow 5,000, for [several reasons](#). I agree that stocks remain overvalued, but think he's a bit too bearish on stocks, and far too bullish on bonds.

Housing

In addition to bonds, investors seeking safety have primarily fled to housing. While it hasn't yet reached bubble proportions nationwide, it's coming close in some cities, generally on the East and West Coasts. Take a look at my hometown, New York City, N.Y. The city is still struggling to recover from 9/11, faces its worst budget crisis in decades, and is reeling from huge layoffs by Wall Street firms, yet housing prices still rose 11% in the year ended June 2002. Having recently bought an apartment there, I can attest to the craziness of the housing market.

And New York is hardly alone. According to the [cover story](#) in this week's *Fortune*, "Since the boom began in 1995, housing prices have jumped 51%, or 32 points above inflation. The run-up has added \$50,000 in wealth, on average, for every one of the nation's 72 million homeowners. In many markets the gains are even more extraordinary. In Boston, home prices have risen more than 110% since 1996, to an average of \$398,000. In San Francisco and San Jose, a three-bedroom ranch will run you about \$500,000, almost twice what it fetched seven years ago."

A recent front-page [story](#) in *The Wall Street Journal* (subscription required) had similar data: "In Miami, home prices have shot up 58% since the beginning of 1998, while incomes have risen only 16%. In New York's Long Island suburbs, an 81% increase in home prices compares with a 14% rise in incomes. In Boston, home prices have jumped 89%, compared with income gains of only 22%. And in some cities, including San Diego, Miami, and Washington, D.C., the run-ups have accelerated in the past year -- confounding expectations that the market would cool off before it got too far out of line."

This kind of nonsense cannot and will not continue -- most obviously because mortgage interest rates are highly unlikely to fall much further (since mid-1990, the rate on a 30-year mortgage dropped from 10.5% to a recent 40-year low of 5.95%). I don't expect a collapse in housing

prices -- rather, they will likely return, at best, to the 5% growth rate of the past 30 years. Stocks are likely, I believe, to do a few percentage points per year better.

Conclusion

The stock market has been, for many people, a frightening place to be for the past few years, but fleeing to bonds or housing right now is the wrong move. If you can stomach the volatility and have a sound investment strategy (admittedly, two very big “ifs”), stocks are a better bet.

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Don't Sell at the Bottom

Investors often panic and sell at precisely the wrong time. Whitney Tilson offers some advice on how to avoid this extremely annoying -- not to mention financially painful -- phenomenon.

By Whitney Tilson

Published on the Motley Fool web site, 11/6/02

(<http://www.fool.com/news/foth/2002/foth021106.htm>)

In my last [column](#), I wrote about investors' unshakable habit of piling into the hottest investment fad at precisely the wrong time. Today, I warn about the opposite, yet equally pernicious, habit: panicking and selling at the bottom.

How many times have you bought a stock or invested in a mutual fund, watched it decline, sold because you couldn't take the pain anymore, and then watched it rebound? It happens all the time, and I'd wager there's not a single investor who hasn't been victimized by this extremely annoying -- not to mention financially painful -- phenomenon.

With such a broad-based decline in the market (unlike last year), there have been few places to hide in 2002, as the great majority of stocks and funds have fallen significantly. If your portfolio has gotten whacked, what should you do? Dump the investments after they've fallen, or hang on in the hope that they'll rebound? I've found this to be the most difficult type of investment decision: distinguishing between genuinely lousy investments that will never bounce back (and thus should be sold immediately) and those that have been unfairly beaten up by the market and should therefore be held or even bought.

Warren Buffett, as always, has great advice. In an [interview](#) in the latest issue of *Fortune*, he was asked if it bothered him that many believed "you were a has-been, that you were through" when Berkshire Hathaway's stock -- and those of many of Buffett's holdings -- were getting pounded during the Internet bubble.

Buffett replied: "Never. Nothing bothers me like that. You can't do well in investments unless you think independently. And the truth is, you're neither right nor wrong because people agree with you. You're right because your facts and your reasoning are right. In the end, that's all that counts. And there wasn't any question about the facts or reasoning being correct."

In other words, to be a successful investor, you must ignore the market and the false signals that it can send out, and instead rely on "your facts and your reasoning" -- nothing else. This advice is undoubtedly correct, but it can be hard to apply in practice.

Evaluating stocks

For example, let's say you bought **AOL Time Warner** ([NYSE: AOL](#)) and **Tyco** ([NYSE: TYC](#)) a year ago at \$33 and \$49, respectively. Now, at \$15 and change each, they're down 52% and 69%. What should you do?

I don't have a strong opinion on either of these stocks, and that's OK, since I don't own either of them. I do, however, have an opinion (and obviously a favorable one) for every stock I own -- and you should too. As I wrote in [Never Too Late to Sell](#):

You should calmly and unemotionally evaluate every one of your holdings. Are there any in which you have lost confidence, or in which you still believe, but think the valuation is too high? Then think very hard about selling. The key question that I ask myself is: 'If I didn't own this stock, would I buy it today?' If not -- and if there are no taxable gains -- then I will usually sell.

As you review your portfolio, keep in mind that a stock doesn't know that you own it. Its feelings won't be hurt if you sell it, nor does it feel any obligation to rise to the price at which you bought it so that you can exit with your investment -- not to mention your dignity -- intact.

Evaluating investment funds

The same principles apply when evaluating investment funds. If you simply look at performance, especially over a short period in such a turbulent market, you are likely to make a bad decision.

Consider what happened to three of the greatest investors of all time during the early 1970s -- the last period in which the U.S. stock market experienced a bubble and subsequent decline comparable to recent history. From 1970 to 1972, investors piled into a handful of premiere growth stocks, labeled The Nifty Fifty, which (at their peak) traded at an average P/E ratio of 42 versus the S&P 500's 19. Then the bubble burst, and in 1973 and 1974, the Dow fell 33.2% (44.4% from peak to trough).

Warren Buffett (who made **Berkshire Hathaway** ([NYSE: BRK.A](#)) his investment vehicle after closing his partnership at the end of 1969), Charlie Munger (who had not yet formally teamed up with Buffett and was running his own partnership), and the **Sequoia Fund's** ([Nasdaq: SEQUX](#)) Bill Ruane all experienced the worst relative and absolute investment performances of their otherwise-spectacular careers during this period. Here's the data:

<u>Yr</u>	<u>S&P 500</u>	<u>Berkshire</u>	<u>Munger</u>	<u>Sequoia</u>
1970	3.9%	-7.1%	-0.1%	n/a
1971	14.6%	79.5%	20.6%	13.5%
1972	18.9%	14.3%	7.3%	3.7%
1973	-14.8%	-11.3%	-31.9%	-24.0%
1974	-26.6%	-43.7%	-31.5%	-15.7%
TOTAL	-11.5%	-4.8%	-39.7%	-24.6%

Note: Berkshire Hathaway's returns are based on year-ending share prices. The Munger Partnership's returns are net to limited partners. The Sequoia Fund was launched on July 15, 1970, and appreciated by 12.1% over the balance of the year, trailing the 20.6% return of the S&P 500 over the same period.

Imagine that you had encountered Warren Buffett at the end of 1975. Impressed with his intellect and investment approach, you would have naturally examined his track record -- and almost certainly, to your everlasting regret, not invested. Why? Because his results, as measured by the stock price of Berkshire Hathaway, were truly dreadful over a *four-year period*. The stock not

only declined and trailed the market during the 1973-74 downturn, but also in the 1975 rebound. Consider this data:

Yr	S&P 500	Berkshire
1972	18.9%	14.3%
1973	-14.8%	-11.3%
1974	-26.6%	-43.7%
1975	37.2%	-5.0%
TOTAL	2.0%	-45.8%

The rest is, of course, history. From \$38/share at the end of 1975, Berkshire Hathaway has risen nearly *2,000 times* to yesterday's closing price of \$73,900. [For more information about the track records of these investors (and many others), plus some of the wisest words ever spoken about investing, see Buffett's famous 1984 speech, [The Superinvestors of Graham-and-Doddsville](#).]

My point is not that you should ignore performance -- it's that you should evaluate money managers based on two things, neither of which has anything to do with short-term investment returns. First, consider their investment approach, and second, their ability to carry out that approach successfully (assuming, of course, that the manager has the requisite integrity).

Conclusion

Countless studies have shown that during turbulent times like these, investors are prone to making hasty, irrational financial decisions. Don't let this happen to you! Now, more than ever, you must block out your emotions and be supremely analytical in evaluating your holdings and making investment decisions.

Guest columnist Whitney Tilson is managing partner of Tilson Capital Partners, LLC, a New York City-based money-management firm. He owned shares of Berkshire Hathaway at the time of publication. Mr. Tilson appreciates your feedback on the [Fool on the Hill](#) discussion board or at Tilson@Tilsonfunds.com. The Motley Fool is investors writing [for investors](#).

Never Too Late to Sell

If you own a “bubble stock” that may be heading toward zero, Whitney Tilson says, you may want to consider selling it rather than holding on in the vain hope that you might recoup your investment. Looking critically at your holdings -- particularly hopelessly depressed ones -- can be difficult, but investors who bail on bad bets before it's too late may preserve both money and sanity.

By Whitney Tilson

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(<http://www.fool.com/news/foth/2001/foth010320.htm>)

It's embarrassing to admit, but when I first started investing, I didn't have the foggiest notion of what I was doing. I thought I did, of course, but now I look back and thank my lucky stars that I didn't lose a lot of money, because by all rights I should have. Thank you Warren Buffett, Charlie Munger, Ben Graham, Philip Fisher and Peter Lynch, among others, for teaching me how to invest sensibly.

I'm going to tell you a story -- one I've never shared with anyone because it makes me look pretty silly -- in the hopes that some people might learn from my experience. It involves my most disgraceful investment, a sham of a company called Streamlogic. (Don't bother trying to find a web site or ticker, as it's long since defunct.)

I heard about the stock from a friend, who got a hot tip from her brother-in-law that it was going to be acquired for \$14. The stock was going nuts on this speculation, rising in a matter of days from \$1 to \$6. I looked up the financials, which were a joke, but greed and ignorance caused me to buy 1,000 shares anyway.

You know where this story's going, don't you? I nailed the top and the stock declined relentlessly over the next few months. Every day I would look at my stock portfolio and there was Streamlogic, scornfully mocking me. It got depressing after a while, but I still didn't sell. Consumed by fatalism, I rationalized to myself that at \$2 a share, it couldn't drop any further. And anyway, there was so little of my investment left that it really didn't matter, right?

One day I snapped out of my funk. I remember thinking, “Wait a second! \$2,000 is real money! There are a lot of better things I can do with that money instead of watching it slowly evaporate.” I had long since recognized that investing in Streamlogic -- at [any](#) price -- was a ghastly mistake, but I was compounding my initial folly by not taking immediate action to rectify the situation. So I sold, salvaging one-third of my original investment. (You won't be surprised to hear that the stock soon went to zero.)

The reason I'm telling you this story is because the emails I've received from my readers over the past few months lead to believe that there are many, many people in similar situations today. They made bad investments in preposterous companies, know now that they made a mistake, [but haven't sold yet](#).

The truth about the Internet bubble

If you got caught up in the excitement over the Internet and made some investments you regret, learn from the experience and vow never to make the same mistake again, but don't be too embarrassed. There were very powerful forces at work that lured even the most sensible people into the party. Warren Buffett wrote about this in his recent annual letter to Berkshire Hathaway shareholders:

“Far more irrational still were the huge valuations that market participants were then putting on businesses almost certain to end up being of modest or no value. Yet investors, mesmerized by soaring stock prices and ignoring all else, piled into these enterprises. It was as if some virus, racing wildly among investment professionals as well as amateurs, induced hallucinations in which the values of stocks in certain sectors became decoupled from the values of the businesses that underlay them.

“The fact is that a bubble market has allowed the creation of bubble companies, entities designed more with an eye to making money *off* investors rather than *for* them. Too often, an IPO, not profits, was the primary goal of a company's promoters. At bottom, the 'business model' for these companies has been the old-fashioned chain letter, for which many fee-hungry investment bankers acted as eager postmen.”

If you own the stocks of any of the sham companies that Buffett is referring to, I suggest that you consider selling them immediately.

Ah, but it's not always obvious which companies are shams, with stocks that are going to zero, and which are survivors, with stocks that might be good investments at today's low prices. How can you tell the difference? There are no easy answers and reasonable people will disagree, but let me give one example of the former: Loudcloud (Nasdaq: LDCL). This company's S-1 (IPO) filing reveals miniscule revenues, enormous losses, a mediocre (at best) business model, and future prospects that depend on taking market share from larger, established companies during a period when customers are retrenching. With no reasonable likelihood of profitability anywhere on the horizon, I can't figure out how Loudcloud is going to survive, much less thrive.

Whether or not Loudcloud eventually succeeds, it is clearly premature to take it public. Yes, hundreds of companies in similar situations went public over the past few years, but that was during a bubble that has now burst. In today's environment, this IPO is a travesty and both the management of Loudcloud and the underwriters, Goldman Sachs and Morgan Stanley Dean Witter, should be ashamed of themselves. Less than a week after going public, the stock is already down 20% -- well on its way to zero, where it probably belongs.

To sell or not to sell

My point is *not* that you should immediately sell any stocks you own -- whether Internet-related or not -- that have declined precipitously. Don't let yourself be frightened into selling a quality company because its stock price has fallen. In fact, you should be delighted by the opportunity to buy more of a stock you like at a lower price, all other things being equal.

Of course, all other things usually aren't equal. Maybe the company has missed earnings or announced bad news. Or maybe you now realize that when you bought the stock, you were counting on a greater fool to buy it from you at a higher price -- but [you](#) ended up being the fool.

My point, in the end, is that you should calmly and unemotionally evaluate every one of your holdings. Are there any in which you have lost confidence, or in which you still believe, but think the valuation is too high? Then think very hard about selling. The key question that I ask myself is: "If I didn't own this stock, would I buy it today?" If not -- and if there are no taxable gains -- then I will usually sell. (For more thoughts on selling, see my December column, To Sell or Not to Sell?)

As you review your portfolio, keep in mind that a stock doesn't know that you own it. Its feelings won't be hurt if you sell it, nor does it feel any obligation to rise to the price at which you bought it so that you can exit with your investment -- not to mention your dignity -- intact.

Conclusion

You can't change the past, but you absolutely can and should take actions today that will benefit your financial future.

After you cleanse your portfolio, then vow, as I did, to forevermore only own stocks in companies and industries you understand well, for which you believe the company and its management are of high quality, and that you can buy at an attractive price.

-- Whitney Tilson

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To Sell or Not to Sell

Studies show that investors cling to stocks they own that have declined, even when they have lost confidence in them. With so many stocks down this year, it is especially critical now that investors think rationally about whether to buy more, hold, or sell their losing stocks.

By Whitney Tilson

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(<http://www.fool.com/news/foth/2000/foth001205.htm>)

I'm interrupting my series on how to analyze cash flow statements and calculate free cash flow because some of the emails I received after last week's [column](#) are troubling me. After reading the first part of my analysis of **Lucent's** ([NYSE: LU](#)) weak cash flows, a number of readers emailed me with comments like these:

"I am with LU to the bitter end."

"I am a recently laid-off former Lucent employee and I thank you for explaining why the stock has 'gone to hell in a handbasket.' However, I wish I would have known before what was left of my 401(k) went out the window. Will I ever get any of it back?"

What troubles me about these emails is that these investors, I fear, are not thinking rationally about their decision to buy more, hold, or sell their Lucent stock. It might well be a good investment at today's prices (I won't be expressing any opinion on this until I finish analyzing Lucent's cash flows in my next two columns) but I think many investors are holding this stock -- and others that have fallen precipitously -- for the wrong reasons.

They're hanging on not because they firmly believe that it is among their very best investment ideas today, but because they are hoping that the stock will rebound to the price at which they bought it so they can sell without incurring a loss. This is among the most common -- and costly -- mistakes that investors make. (Terrence Odean, who has done a number of fascinating [studies](#) on investor behavior, published a paper, [Are Investors Reluctant to Realize Their Losses?](#), which shows that investors are twice as likely to sell their winners as their losers.)

Losing money on a stock -- even if only on paper -- is a painful thing. (Those of you who have read my [columns](#) on **American Power Conversion** ([Nasdaq: APCC](#)) know that I speak from personal experience.) This pain can trigger irrational, destructive decisions, especially among less-experienced investors. Millions of people were lured into picking stocks for the first time over the past year or two by the false promise of easy riches. Until recently, they had known nothing but a euphoric bull market, but many are now sitting on losses of 50%, 80%, or more in certain stocks. Uncertainty, fear, and even panic are the widespread consequence. It is absolutely critical during times like these to be supremely rational when making investment decisions.

Why investors cling to mistakes

Even the most successful investors make mistakes. What generally differentiates them from the

rest of the pack is that they minimize the number of mistakes and, equally importantly, quickly recognize, acknowledge, and sell mistakes. Regarding the latter, you would think that once investors had come to realize that they had made a mistake in buying a stock, then selling would be a natural next step. Unfortunately, this is often not the case, especially when it involves selling at a loss. Why? Forty-two years ago in his timeless classic, [Common Stocks and Uncommon Profits](#), Philip Fisher nailed the answer on the head:

“There is a complicating factor that makes the handling of investment mistakes more difficult. This is the ego in each of us. None of us likes to admit to himself that he has been wrong. If we have made a mistake in buying a stock but can sell the stock at a small profit, we have somehow lost any sense of having been foolish. On the other hand, if we sell at a small loss we are quite unhappy about the whole matter. This reaction, while completely natural and normal, is probably one of the most dangerous in which we can indulge ourselves in the entire investment process. More money has probably been lost by investors holding a stock they really did not want until they could ‘at least come out even’ than from any other single reason. If to these actual losses are added the profits that might have been made through the proper reinvestment of these funds if such reinvestment had been made when the mistake was first realized, the cost of self-indulgence becomes truly tremendous.”

This sentence bears repeating: “More money has probably been lost by investors holding a stock they really did not want until they could ‘at least come out even’ than from any other single reason.” Don’t fall victim to this trap! As my friend says: “Don’t let what you want change what is. You don’t have to make it back the same way you lost it.”

Thinking rationally

Now that we understand that it is normal to irrationally resist selling a losing stock, how can we reorient our thinking? Here’s how I do it: In my mind, I assume that my entire portfolio is 100% cash. Then I ask myself, “How would I invest this cash? Which stocks would I buy? What would my new built-from-scratch portfolio look like?”

I urge you to do the same mental exercise. Now compare your hypothetical new portfolio with your current one. Is it different? Are there any stocks in your current portfolio that you wouldn’t buy today if you had 100% cash? If so, then why on earth don’t you sell them immediately?

One good answer is that you are sitting on a big capital gain and don’t want to pay the taxes. That’s a good reason, as taxes are a real cost. (It’s an especially good reason near the end of the year, when by delaying selling by less than a month, you can defer paying the taxes for an entire year.) Let’s say you were lucky enough to buy **Cisco** ([Nasdaq: CSCO](#)) at its IPO, meaning that your cost basis is a few pennies per share. If you sold at \$50, you would have to pay \$10/share in taxes assuming the 20% long-term capital gains tax rate. That means you would be trading \$50 of Cisco for \$40 of another stock. Do you have that much confidence in another stock (or, conversely, are you quite certain that Cisco’s stock will decline)? While I’m a proponent of long-term investing, if you’re confident that the answer to either of these questions is yes, then sell.

The decision to sell should be much easier if you have a loss on a stock (assuming, as noted above, that you would not buy the stock today if you didn’t own it). Think of it this way: Uncle

Sam is *paying* you to sell! Losing money on a stock is no fun, but a tax loss can soothe the pain a bit.

Conclusion

As I've written in many previous [columns](#), the price you pay for a stock is a critical determinant of your return. But once you own a stock, your purchase price is irrelevant to your decision whether to buy, sell, or continue holding -- other than to consider taxes.

Let me be very clear: I am not advocating that you blindly sell your losing stocks. That would be falling into another trap that studies have identified: investors have a terrible habit of buying at the top and selling at the bottom. In fact, all other things being equal, you should be an even more eager buyer at a lower price, since the best time to buy is when the stock of a good company has been beaten down due to external or short-term issues.

Ah, but all other things *aren't* always equal. Companies and industries change. New information surfaces. Assumptions can prove to be inaccurate. Stocks often decline for very good reasons, and you might be correct in concluding that there are better places for your capital, even though the stock has become cheaper. The key is figuring out which stocks are mistakes and which represent opportunity. That's not easy, but it is certainly much easier if you can overcome the natural human tendency to irrationality cling to losing stocks.

-- Whitney Tilson

Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for the Motley Fool and other writings, click [here](#).

Munger Goes Mental

Charlie Munger, the famed right-hand man of Warren Buffett, gave a brilliant speech last October at the University of California, Santa Barbara. With Munger's permission, Whitney Tilson is publishing a transcript for the first time -- a Motley Fool exclusive! -- and shares the highlights in this column.

By [Whitney Tilson](#)

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(www.fool.com/news/commentary/2004/commentary040604wt.htm)

Berkshire Hathaway's ([NYSE: BRK.A](#))([NYSE: BRK.B](#)) Warren Buffett and Charlie Munger are undoubtedly the greatest investment duo ever, so I think any sensible investor should try to learn as much as possible about these two men and how they achieved their success. In the case of Buffett, it's not hard -- there are many books about him, he's published lengthy annual letters for decades (you can read the last 27 of them for free on Berkshire's [website](#)), and he gives speeches and makes public appearances regularly. But Munger is more private; there are only [two books](#) about him, he is a far less prolific writer, and rarely gives speeches.

Thus, my heart skipped a beat when a friend gave me a recording of a speech Munger gave to the economics department at the University of California, Santa Barbara last Oct. 3. It's 85 minutes long and entitled, "Academic Economics: Strengths and Faults After Considering Interdisciplinary Needs."

With that kind of title, it sounds like a real snoozer, eh? But it's not. In this speech, Munger applies his famous mental models approach to critiquing how economics is taught and practiced, and I think the lessons he teaches are profound -- both for investors as well as anyone who seeks to be a better, clearer thinker.

I transcribed the speech for my own benefit, but after making such an effort (it took forever, as it's 21 single-spaced pages), I thought that others might be interested in Munger's wisdom, so I sent him a copy and asked if I could publish it. He asked me not to until he'd had a chance to review it and make some edits. He has now done so, so I'm delighted to share it with you: [Click here](#) to read it.

In this column, I will share some of the highlights of the speech.

Berkshire's success

Munger started his speech by highlighting his credentials to talk about economics -- namely the extraordinary success of Berkshire Hathaway over the years he and Buffett have been running it (Buffett ran it for a few years before Munger joined him):

When Warren took over Berkshire, the market capitalization was about ten million dollars. And forty something years later, there are not many more shares outstanding now than there were then, and the market capitalization is about a hundred billion dollars, ten thousand for one. And since that has happened, year

after year, in kind of a grind-ahead fashion, with very few failures, it eventually drew some attention, indicating that maybe Warren and I knew something useful in microeconomics.

Efficient market theory

Buffett and Munger have always heaped scorn upon the academics who cling to the efficient market theory, unable to distinguish between an obvious truth -- that the market is mostly efficient most of the time -- and obvious nonsense -- that the market is always perfectly efficient all of the time:

Berkshire's whole record has been achieved without paying one ounce of attention to the efficient market theory in its hard form. And not one ounce of attention to the descendants of that idea, which came out of academic economics and went into corporate finance and morphed into such obscenities as the capital asset pricing model, which we also paid no attention to. I think you'd have to believe in the tooth fairy to believe that you could easily outperform the market by seven-percentage points per annum just by investing in high volatility stocks. Yet...many people still believe it. But Berkshire never paid any attention to it.

Multidisciplinary education and “man with a hammer syndrome”

Over the years, Munger has always preached the importance of learning -- and then using -- all of the big disciplines, such as math, science, psychology, etc. To him, this just came naturally:

For some odd reason, I had an early and extreme multidisciplinary cast of mind. I couldn't stand reaching for a small idea in my own discipline when there was a big idea right over the fence in somebody else's discipline. So I just grabbed in all directions for the big ideas that would really work. Nobody taught me to do that; I was just born with that yen.

If one doesn't embrace all multidisciplinary thinking, Munger argues, then one is likely to fall into the trap of:

“man with a hammer syndrome.” And that's taken from the folk saying: To the man with only a hammer, every problem looks pretty much like a nail. And that works marvelously to gum up all professions, and all departments of academia, and indeed most practical life. The only antidote for being an absolute klutz due to the presence of a man with a hammer syndrome is to have a full kit of tools. You don't have just a hammer. You've got all the tools. And you've got to have one more trick. You've got to use those tools checklist-style, because you'll miss a lot if you just hope that the right tool is going to pop up unaided whenever you need it.

Problems to solve

During his speech, to illustrate the types of questions his ways of thinking will help answer, Munger posed a number of problems to solve:

1. There's an activity in America, with one-on-one contests, and a national championship. The same person won the championship on two occasions about 65 years apart. Name the activity.
2. You have studied supply and demand curves. You have learned that when you raise the price, ordinarily the volume you can sell goes down, and when you reduce the price, the volume you can sell goes up. Now tell me several instances when, if you want the physical volume to go up, the correct answer is to increase the price?
3. You own a small casino in Las Vegas. It has 50 standard slot machines. Identical in appearance, they're identical in the function. They have exactly the same payout ratios. The things that cause the payouts are exactly the same. They occur in the same percentages. But there's one machine in this group of slot machines that, no matter where you put it among the 50, in fairly short order, when you go to the machines at the end of the day, there will be 25% more winnings from this one machine than from any other machine. What is different about that heavy-winning machine?

For the answers to these questions, you'll have to read the transcript.

Second- and third-order consequences and free trade

Munger gave a number of examples of how often people only look at immediate consequences of certain actions and fail to consider second- and third-order consequences. For example:

Everybody in economics understands that comparative advantage is a big deal, when one considers first-order advantages in trade from the Ricardo effect. But suppose you've got a very talented ethnic group, like the Chinese, and they're very poor and backward, and you're an advanced nation, and you create free trade with China, and it goes on for a long time.

Now let's follow and second- and third-order consequences: You are more prosperous than you would have been if you hadn't traded with China in terms of average well-being in the U.S., right? Ricardo proved it. But which nation is going to be growing faster in economic terms? It's obviously China. They're absorbing all the modern technology of the world through this great facilitator in free trade and, like the Asian Tigers have proved, they will get ahead fast. Look at Hong Kong. Look at Taiwan. Look at early Japan. So, you start in a place where you've got a weak nation of backward peasants, a billion and a quarter of them, and in the end they're going to be a much bigger, stronger nation than you are, maybe even having more and better atomic bombs. Well, Ricardo did not prove that that's a wonderful outcome for the former leading nation. He didn't try to determine second-order and higher-order effects.

If you try and talk like this to an economics professor, and I've done this three times, they shrink in horror and offense because they don't like this kind of talk. It really gums up this nice discipline of theirs, which is so much simpler when you ignore second- and third-order consequences.

Open-mindedness

How many people do you know who actively seek out opinions contrary to their own? Munger certainly does. For example, he said:

...take [Paul Krugman](#) and read his essays, you will be impressed by his fluency. I can't stand his politics; I'm on the other side. [Krugman constantly bashes Republicans and the Bush administration on the Op Ed page of *The New York Times*.] But I love this man's essays. I think Paul Krugman is one of the best essayists alive.

Destroying your own best-loved ideas

Munger believes that it's absolutely critical not to "cling to failed ideas." You must become good, he argues, "at destroying your own best-loved and hardest-won ideas. If you can get really good at destroying your own wrong ideas, that is a great gift."

How important this is when it comes to investing! Not long ago, I publicly recommended a stock, yet a few weeks later, based on new information, I came to the conclusion that it was no longer a good idea. A natural tendency would have been to hold on to the stock and refuse to admit to my readers that I might have been mistaken. Making it even harder to sell was the fact that the stock had declined - why not wait until it rebounded to the price at which I had bought it, right? (This is a deadly error, as I've discussed in [previous columns](#).) Fortunately, I did sell, refusing to "cling to failed ideas."

Chutzpah

I'll conclude this column with a bit of classic Munger humor: While Buffett bends over backward to appear humble, Munger's the opposite -- he jokes about his big ego. In his opening remarks, he said:

As I talk about strengths and weaknesses in academic economics, one interesting fact you are entitled to know is that I never took a course in economics. And with this striking lack of credentials, you may wonder why I have the chutzpah to be up here giving this talk. The answer is I have a black belt in chutzpah. I was born with it.

Contributor Whitney Tilson is a longtime guest columnist for The Motley Fool. He owned shares of Berkshire Hathaway at press time, though positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your [feedback](#). To read his previous columns for The Motley Fool and other writings, visit www.tilsonfunds.com. The Motley Fool is [investors writing for investors](#).

Munger on Human Misjudgments

Charlie Munger gave an insightful speech on “24 Standard Causes of Human Misjudgment,” which has powerful implications for investors. Whitney Tilson summarizes some key points and provides a link to the speech, so you can read for yourself.

By Whitney Tilson

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(<http://www.fool.com/news/foth/2002/foth020821.htm>)

Behavioral finance -- which examines how people’s emotions, biases, and misjudgments affect their investment decisions -- is one of the least discussed and understood areas of investing. Yet I believe it’s critically important -- so important, in fact, that I covered it in my very first [column](#) (in September 1999, which seems like an investing lifetime ago, doesn’t it?).

Behavioral finance recently reappeared on my radar screen when I came across an 80-minute recording of a speech given by **Berkshire Hathaway** ([NYSE: BRK.A](#)) Vice Chairman Charlie Munger, Warren Buffett’s right-hand man and a genius in his own right. It’s a brilliant, powerful, and compelling tour de force.

In it, Munger highlights what he calls “24 Standard Causes of Human Misjudgment,” and then gives numerous examples of how these mental weaknesses can combine to create “lollapalooza” effects, which can be very positive -- as in the case of Alcoholics Anonymous -- or frighteningly negative, such as experiments in which average people end up brutalizing others.

I’d like to highlight some of Munger’s most important lessons, especially as they relate to investing.

Psychological denial

Munger notes that sometimes “reality is too painful to bear, so you just distort it until it’s bearable.” I see this all the time among investors -- both professionals and average folks. Think of all the people who simply have no business picking stocks, such as the “bull market geniuses” of the late 1990s, whose portfolios have undoubtedly been obliterated in the bear market of the past two and a half years.

You’d think these people would’ve recognized by now that whatever investment success they had in the late ‘90s was due solely to one of the most massive bubbles in the history of stock markets, and that they should get out while they still have even a little bit of money left. I’m sure some are doing so, but many aren’t because they’d have to acknowledge some extremely painful truths (e.g., they should not, and should never have been, picking stocks; they speculated with their retirement money and frittered most of it away, and so on).

Instead, I’m still getting emails like this one, from people who, I suspect, are in serious psychological denial:

Why isn't anyone suggesting WorldCom as an investment possibility? Assuming WorldCom survives, and assuming they reach a third of their highest stock value prior to the decline, why not buy shares at \$0.19 (as listed now) [they're now down to \$0.124] and hold them for a few years? If WorldCom manages to make it back to \$10.00 a share, the profit for a small investor would be more than satisfactory. What am I missing here? It seems like another chance to 'get in on the ground floor.'

The answer is that WorldCom equity is almost certain to be worthless, and the only sane people buying the stock right now are short-sellers covering their very profitable shorts.

Bias from consistency and commitment tendency

Munger explains this bias with the following analogy: "The human mind is a lot like the human egg, and the human egg has a shut-off device. When one sperm gets in, it shuts down so the next one can't get in." In other words, once people make a decision (to buy a stock, for example), then it becomes extremely unlikely that they will reverse this decision, especially if they have publicly committed to it.

This is true even if overwhelming evidence emerges indicating the initial decision was disastrously wrong. Have you ever bought a stock such as Lucent, Enron, or WorldCom, seen your original investment thesis torn to shreds by subsequent developments -- such that you would never consider buying more of the stock (despite the lower price), *yet you didn't sell*? I've written [two columns](#) on this common, painful mistake.

Over-influence by social proof

Human beings have a natural herding tendency -- to look at what everybody else is doing and do the same, however insane that behavior might be. Munger gives a classic example from corporate America:

Big-shot businessmen get into these waves of social proof. Do you remember some years ago when one oil company bought a fertilizer company, and every other major oil company practically ran out and bought a fertilizer company? And there was no more damned reason for all these oil companies to buy fertilizer companies, but they didn't know exactly what to do, and if Exxon was doing it, it was good enough for Mobil, and vice versa. I think they're all gone now, but it was a total disaster.

Similar behavior led to the tech stock bubble of the late 1990s. For more on this topic, see my column [The Cocktail-Party Test](#), in which I argue, "Following the crowd and investing in what is fashionable is a recipe for disaster. Instead, look for solid companies with strong balance sheets that are either out of favor with Wall Street or, better yet, not even on Wall Street's radar screen."

Other questions Munger answers

I've cited only a few examples of Munger's powerful observations and the answers he gives to a range of perplexing questions, such as:

- Why are boards of directors so consistently dysfunctional and unable to rein in even the most egregious behavior by CEOs?
- Why was the introduction of New Coke almost one of the costliest business blunders of all time?
- Why didn't Salomon's CEO John Gutfreund or General Counsel Donald Feuerstein immediately turn in rogue employee Paul Mozer -- a failure of judgment that cost both men their careers and nearly put Salomon out of business?
- How did Joe Jett lose \$210 million for Kidder Peabody (and parent company GE)?
- How did Federal Express solve the problem of processing all of its packages overnight?
- Why wouldn't Sam Walton let his purchasing agents accept even the tiniest gift from a salesperson?
- How does Johnson & Johnson ensure that it evaluates and learns from its experience making acquisitions?
- How has Tupperware "made billions of dollars out of a few manipulative psychological tricks?"
- Why do bidders consistently overpay in "open-outcry" actions?
- Why is a cash register "a great moral instrument?"
- Why would it be evil *not* to fire an employee caught stealing?
- Why might raising the price of a product lead to *greater* sales?
- Why do some academicians continue to cling to the Efficient Market Theory?
- Why are people who grow up in terrible homes likely to marry badly? And why is it so common for a terrible first marriage to be followed by an almost-as-bad second marriage?
- How can real estate brokers manipulate buyers?
- How do lotteries and slot machines prey on human psychology?
- Why should we be grateful that our founding fathers were "psychologically astute" in setting the rules of the U.S. Constitutional Convention?

There is no space here to even begin to summarize Munger's answers to these questions, so I transcribed his speech and posted it [here](#). I urge you to read it.

If you find his thinking and the field of behavioral economics as fascinating as I do, I suggest reading [*Influence*](#), by Robert Cialdini, [*Why Smart People Make Big Money Mistakes*](#), by Gary Belsky and Thomas Gilovich and, for the definitive work on Munger himself, [*Damn Right! Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger*](#), by Janet Lowe.

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