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By John Mauldin

This week we look at the "The Triumph of Irrational Expectations over Long Run Experience." It is a cautionary tale, but enjoyable in the telling, and one that investors almost invariably ignore to their own chagrin. Also, at the end of this letter, I tell you how to get a free coy of Andy Kessler's book, "How We got Here." This is a book you want to read and then give to your kids.

This past weekend, I along with my partners at Altegris Investments sponsored a conference for accredited investors. In addition to a number of investment managers, attendees heard from Richard Russell, Paul McCulley, Rob Arnott, Andy Kessler and Mark Finn, as well as yours truly. We recorded the main sessions, and in some future letter, I will tell you how you can get a copy of their speeches for your listening pleasure.

I will spend the next few weeks, going over some of the key concepts that we heard at the conference (and add a few comments of my own, and a point or two where I might disagree, of course). We're going to first address a speech by Mark Finn, entitled "Propaganda, Miracles and Past Performance," with the subtitle as noted above: "The Triumph of Irrational Expectations over Long Run Experience."

Mark Finn of Vantage Consulting has spent years analyzing trading systems. He is a consultant to large pension funds and Fortune 500 companies. He is one of the more astute analysts of trading systems, managers, and funds that I know. He's put more start-up managers in the business than perhaps anyone in the fund management world. He has a gift for finding new talent and deciding if their ideas have investment merit.

He has a team of certifiable mathematical geniuses working for him. They have access to the best pattern recognition software available. They have run price data through every conceivable program and come away with this conclusion:

Past performance is not indicative of future results. And that was the thrust of his speech.

Actually, Mark says it more like: past performance is pretty much worthless when it comes to trying to figure out the future. I would note that past performance has its uses, but agree that predicting the future is not one of them.

Yet we all (including me) get caught up in looking at past performance. Today we'll look at Mark's thoughts on why that is and what we can do to stop. Let's start with a quote from G. K. Chesterton. (I suggest you read it twice, once to catch its meaning and once for the beauty of the phrasing.)

> "The real trouble with this world of ours is not
> that it is an unreasonable world, nor
> even that it is a reasonable one.
> The commonest kind of trouble is that it is
> nearly reasonable, but not quite.
> Life is not an illogicality, yet
> it is a trap for logicians.
> It looks just a little more mathematical
> and regular than it is; its'
> exactitude is obvious; but
> its' inexactitude is hidden;
> its' wildness lies in wait."

The Problem of Propaganda

Past performance is the most misused statistic in investments. Mark lays part of the blame for this at the feet of propaganda, but not the type of propaganda that we would associate with political movements - it's far more subtle.

There are two types of propaganda. There is "hot" propaganda. Hot propaganda is rumor with the volume turned up. It is someone screaming that "butter is bad" without having to prove it. "Cold" propaganda uses authoritative sources to back its assertions. Cold propaganda relies on facts and logic. Hot propaganda relies on innuendo, often trying to create anxiety or concern where a more rational observation would find neither.

For propaganda to be at its most effective there needs to be a steady flow of it. Even if an item is not true, if it is repeated long enough and by enough sources, especially if it is through trusted sources, it can become accepted.

Propaganda plays on our anxieties. For instance, let's look at the anxiety we have about our investments. If we have had recent poor performance, and we hear something negative about our current investments, do we not become more anxious? Propaganda tries to create a sense of urgency. We are told, "This investment opportunity, will only be available for another two weeks. Get in now before it goes away forever."

Of course the opportunity may in fact be going away in two weeks, and it may be a very good one, but that sense of urgency can short-circuit our normal rational thought process if we are not careful.

Propaganda takes advantage of several types of psychological processes. First there's a principle of generality. Think motherhood, apple pie and Lassie. When something has a positive connotation, we are less likely to give it the full scrutiny that it deserves. We feel more comfortable with it. An example would be hedge funds. Five to ten years ago you almost had to apologize if you introduced a hedge fund to a private investor. The term hedge fund was fraught with negative connotations. While there are still "issues" about hedge funds with much of the mainstream press, hedge funds have a more positive connotation today than in the past. And that means it's more likely we will use past performance as the main basis for our hedge fund selection, just as most investors use past performance as the primary criteria for the mutual fund selection. (More on this topic later.)

Then there is the bandwagon effect, where the more we see our friends and other people do something, the more we feel the need to participate. How often do we come to a street corner, and when someone crosses against the red light, we and everybody around us joins in? That person has "given us permission" to break the rules. In the excellent book "The Tipping Point" by Malcolm Gladwell, he writes about this "permission" process in detail. Joining the crowd is part of our human nature and is a powerful psychological motivator.

Then there is a problem of transfer. We take one set of past facts and transfer it into a potential new reality. It's a variation of the ever-popular "what if?" game. Specifically, we look at the past performance of a mutual fund, hedge fund or other investment and project those returns into the future of our investment portfolios. What if I had done this one year ago? Or worse: What would my portfolio look like in one year from today if I could get returns like those in the last year? There is no human being on earth that has not done this. It is warp and woof of our human nature.

Mark then focused for a minute on hedge funds. In one sense, investors had an advantage a few years ago. The track records of most hedge funds were very short and there was very little positive propaganda. Thus, everyone approached hedge funds cautiously. That is beginning to change today, and Mark (and I) see this as a potential problem. An investor should never be complacent about any investment, let alone hedge funds. It is simply part of human nature that long track records (past performance) give us an inappropriate sense of confidence.

Information Versus Accuracy

Mark then refers to an essay by Richards J, Heuer, Jr. entitled "Do You Really Need More Information?" It was published in a book called "Inside CIA's Private World: Declassified Articles from the Agency's Internal Journal 1955-1992." I wrote the following about this article last October;

Buried among articles in the book on how (and how not to!) to spy is this rather straightforward piece on what to do with the information you get and the problems with objective and accurate analysis that are caused by our human thought process. The essay is quite timely, even though it was written in the spring of 1979. While reading the critique, one could not help but wish that it would be required reading at the CIA today. Perhaps we could have avoided a few problems. But that is a topic for someone else. Our beat today is thinking about money. (All quotes are from the article. If you are interested in the complete article, you can go to http://www.cia.gov/csi/books/19104/ and click on chapter 5.)

I am guilty. Mea Culpa. I am constantly researching, looking at (sometimes obscure) data, trying to discern patters and trends. But what to do with all of it? How do we filter it into useful and investable ideas?

"This article challenges the often implicit assumption that lack of information is the principal obstacle to accurate intelligence estimates....Once an experienced analyst has the minimum information necessary to make an informed judgment, obtaining additional information generally does not improve the accuracy of his estimates. Additional information does, however, lead the analyst to become more confident in his judgment, to the point of overconfidence."

Horse Racing and the CIA

Heuer describes a study done about betting on horse races. They took 8 professional handicappers (someone who sets the betting odds based on calculations of the outcome of a contest, especially a horse race) and asked them to rank 80 different pieces of data about a horse race as to what they thought was most important. Do you factor in the jockey's record as well as the recent record of the horse? The weather? The competition? How much weight is the horse carrying? What is the length of the race? There are scores of variables.

Then the handicappers were given what they felt was the five most important pieces of data and asked to project the winners for a race (actual names and races were not given, so as to not bias the projections). They were also asked to rank their confidence about their predictions.

Now it gets interesting. They were then given 10, 20 and 40 pieces of what they individually considered to be the most important information. Three of the handicappers actually showed less accuracy as the amount of information increased, two improved their accuracy, and three were unchanged. But as a group, their accuracy did not improve and in fact was slightly down.

But with each increase in information, their confidence went up. In fact, by the end, their confidence has in fact doubled. If they had actually been at the track and betting, would they have doubled their bets as they became more confident? Human nature says "yes, they would." But that confidence would not have made them any better predictors. They just doubled their bets which magnified their gains or losses. Think of it like adding leverage to your stock portfolio.

"A series of experiments to examine the mental processes of medical doctors diagnosing illness found little relationship between thoroughness of data collection and accuracy of diagnosis." Another study was done with psychologists and patient information and diagnosis. Again, increasing knowledge yielded no better results but significantly increased confidence.

The inference is clear and quite important: “Experienced analysts have an imperfect understanding of what information they actually use in making judgments. They are unaware of the extent to which their judgments are determined by a few dominant factors, rather than by the systematic integration of all available information. Analysts use much less available information than they think they do.”

How can this be? Heuer notes that individuals tend to: “...overestimates the importance he attributes to factors that have only a minor impact on his judgment, and underestimates the extent to which his decisions are based on a very few major variables... Possibly our feeling that we can take into account a host of different factors comes about because although we remember that at some time or other we have attended to each of the different factors, we fail to notice that it is seldom more than one or two that we consider at any one time."

As I wrote in Bull's Eye Investing, “The two most common biases are *overoptimism* and *overconfidence*. For instance, when teachers ask a class who will finish in the top half, on average around 80 percent of the class think they will! Not only are people overly optimistic, but they are overconfident as well. People are surprised more often than they expect to be. For instance, when you ask people to make a forecast of an event or a situation, and to establish at what point they are 98 percent confident about their predictions, we find that the correctness of their predictions ranges between 60 and 70 percent! What happens when we are only 75 percent sure or are playing that 50-50 hunch?”

(As an aside, an excellent book to read on intuition and hunches is called “Blink,” again by Malcolm Gladwell. I may do part of an e-letter on this book in the future. I highly recommend it.)

So how can we overcome the problems of propaganda, over reliance on past performance and overconfidence? Mark gives us a few clues.

First we should study failure. In order to be able to differentiate between success and failure we need to know what both look like. It is surprising how difficult it is to tell success from failure. Sadly, success and failure often look a lot alike until the failure event, which in hindsight we all think we recognized (another human psychological weakness). If it were easy to see failure in advance, no one would invest in any enterprise that one could see was going to fail. Studying past failures gives us clues as to the signs for which we should be looking in advance.

Secondly, we should systematically interview managers in massively out of favor spaces. We need to keep ourselves familiar with the potential areas of investment which are currently the “dogs” of the market. Think commodities, gold and energy only a few years ago. Now they are everybody’s darling. Even if you don't invest in it you should know about it. The time will come when today's dogs will be tomorrow's top performers. Sometimes it takes 20 years, as in the case of gold or commodities, for investment to begin the long crawl back to the top.

I would add it also pays to think about those investments which everybody currently loves. We all know that nothing stays on top forever. Not only do we want to avoid being in such an investment, which is getting ready to go down, but there are also opportunities to take advantage of a drop in prices.

Next he tells us to beware of experts. He gave a great quote from Thomas J. Watson, who was chairman of IBM in 1943: "I think there is a world market for about five computers." Experts overestimate their own edge. They have so much data they fail to see the randomness component in their assumptions. I am not saying that experts do not have some inherent disadvantage relative to non-experts; however, it is the case that experts often believe that they have it "figured it out." They fail to see that the market prices and marginalizes their insights.

It is their familiarity with the subject that sometimes breeds overconfidence. They often fail to see that as G. K. Chesterton noted: "wildness lies in wait." It is the lion crouching hidden in the tall grass, waiting to surprise us, that we should be concerned about.

"…Life is not an illogicality, yet
it is a trap for logicians.
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This is not to say that you should not rely on the advice and expertise of counselors. It is a simple fact that modern life is so complicated that we do indeed need experts. We also need to realize that they are human. Solomon tells us that there is wisdom in multiple counselors. That seems like good advice to me.

Finally, Mark points us to what he calls "reduced clue analysis." We need to focus on a few simple things, thinking about the context of the problem (or investment opportunity) and controlling the frame of the questions. Does the investment or fund have the opportunity to make money in the future, or has all the profit been wrung out of an opportunity? Is it at the top of its path, or just ready to set out on a new upward course?

A brilliant manager who focuses on an area in which there is only a small opportunity cannot work miracles. That is why relying on past performance is so dangerous.

We should also focus on what "edge" any individual manager brings to the table. And never forget to ask, "Where is the manager's money?"

I wrote the following paragraphs in my chapter on "due diligence" in Bull's Eye Investing:

"The most important thing to understand about a fund is 'Why' it makes money. If you cannot understand the 'Why' of a fund, you should not be investing. This is the critical question that will help you understand what the dominant factor in performance of the fund is: skill or luck. As I stated earlier, luck always runs out, typically just after you invest. More funds are based upon luck or random chance than you might think, but I can guarantee you no fund manager will admit it, and most of them would be insulted if you said so. Genius is a rising market, and good performance has persuaded more than one manager they are geniuses. Avoiding such genius is crucial to capital preservation. Finding true investment ability (genius or not) is the secret to capital growth.

"The next most important question is 'How' the fund makes money. What are the strategies and systems used, and what is the risk taken? If you can get a good feeling about those two questions, then you follow up with the more mundane but critical questions of 'Who,' operational issues, structure, safety of assets and, of course, performance."

Now a little full disclosure is called for here. I'm very good friends with Mark, and we have looked at more than one fund together over the years. I know for a fact that he actually does look at past performance, albeit within context. I posed the following thought to him: "Past performance does have its uses. Among other things, it allows you to see how a manager did in a given set of economic and financial circumstances. You must recognize that it is not likely that the manager can repeat that performance, unless he has the same set of economic and financial circumstances. Past performance can also give you a clue as to the risk management techniques of individual managers."

He shot back with, "I don't want to give people the idea that past performance is ok. It is an addictive drug. It is like going to the Betty Ford Clinic and telling people it is okay to drink in moderation. It just gives them an excuse to go out and start drinking again. Nobody I know can use past performance appropriately. It is just too big a narcotic."

Free Books, Baseball and Old Friends

As for the free book I mentioned at the beginning of this letter, my friend Andy Kessler has written a dynamite book called "How we Got Here: A Slightly Irreverent History of Technology and Markets." Expanding on themes first raised in his tour-de-force, Running Money, Andy Kessler unpacks the entire history of Silicon Valley and Wall Street, from the industrial revolution to computers, communications, money, gold and stock markets. These stories cut [by an unscrupulous editor] from the original manuscript were intended as a Primer on the ways in which new technologies develop from unprofitable curiosities to essential investments.

"How We Got Here" connects the dots through history to how we got to where we are today. The book is well written and fun. You can get a free PDF download of the book at http://andykessler.com/hwgh.html. Or you can pre-order a copy (for June delivery) at Amazon.com. I highly recommend this book for your kids, especially those already in or getting ready to go to college.

My very good friend John Dawson, who is President of Youth With A Mission, (the world's largest missionary organization), is spending a few days in my home. It has been a few years since we have been in the same part of the world. Having him here reminds me how important friends are in our lives, and how easy it is to let "busy" get in the way of the more important work of staying in touch. We will catch up, watch the Red Sox play the Rangers and go see Hitchhiker's Guide. John is an uncle to my kids, and we will all have dinner on Saturday. It will be a good week. Family, friends, sci-fi and baseball. How much better can it get?

Your leaving the office early for a change analyst,

John Mauldin