

Failing Conventionally

“Finally it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism..... For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”

- John Maynard Keynes, *The General Theory of Employment, Interest and Money*, “Chapter 12 - The State of Long-Term Expectation”

Keynes had it right. On Wall Street, joining a crowd is particularly alluring – and particularly dangerous. But why? We generally think of popularity as a good thing – what makes investing different than, say, buying breakfast cereal?

You buy cereal for a fixed price and enjoy the breakfasts you consume. The popularity of the particular cereal brand does not affect the benefit you obtain. Now imagine that the cereal fluctuates wildly in price as a result of the day to day changes in consumer popularity. You want to have a delicious breakfast, but the more it costs you, the worse off you are. The cereal might be scrumptious, but if it costs \$100 a box, you will be unlikely to buy it. With a fluctuating price, your benefit from buying depends both on how tasty the cereal is and how much it costs to buy.

A stock is like the cereal with the fluctuating price. There are two different realities for the stock – business and investment. The business reality is the underlying fundamental condition of the company, whether the company will make money. This may have little to do with the stock price on a given day. The company’s stock price is a derivative of this business reality, reflecting what investors are willing to pay for their assessment of the business and its prospects. Investor perceptions will fluctuate above and below that reality, but ultimately they are tethered to it.

The investment reality of the stock is not whether the company will make money, but whether you will make money when you buy and sell the company's stock. The stock price already reflects its popularity. The worst time to buy the stock (and best time to sell) is when it is most popular, since its price is the farthest above the underlying business reality. The best time to invest (and worst time to sell) is when a stock is least popular, since its price is the farthest below the underlying business reality.

Unfortunately, we all want to be popular, and we seem to have an innate tendency to extrapolate the recent past into the future. If a stock has gone up, we tend to believe it will continue to rise, and it becomes more popular. It is easy to chase performance, but hard to perceive underlying business reality. Consequently, we are likely to seek comfort in popularity, just as an insecure high school student is likely to be a slave to the current fashion, no matter how bizarre. The same person shunning the high-priced cereal will rush to buy a stock made too expensive by its popularity.

The clever marketers in the financial services industry are well aware of our inner war between reality and the desire for popularity. The industry constantly emphasizes "products" that are popular and can be easily sold. There is always a huge, newly-created supply of whatever investments are currently the worst values and potentially the most destructive to investor portfolios. It is as bad as if the cereal manufacturers only produced the ridiculously expensive cereal and then created the demand for it.

Bad advisers (and their ads) tell you truths that are already priced into the market or lies that you want to believe. They reinforce. Good advisers tell you things you may not want to believe. They unsettle.

Ads for financial products prey on your desire to be a "player," someone in the know. But being a player is no fun if you don't have company - you want to do what your friends are doing, or, even better, to have your friends see how smart you are. The ads never show somebody professing an opinion that is seriously out of step with others and everyone laughing at how foolish he seems. Instead, the ads tell you conventional truths

(that are already priced into the market) or falsehoods you want to believe. They reinforce what you already think you "know" - comforting, but unlikely to make you money. Good investment advisers are likely to disturb you, to tell truths that are in conflict with your existing viewpoint. They unsettle you by telling things you do not know and that may be hard for you to believe. They are unconventional.

Conventional thinking leads to failure in investing, while the right kind of unconventional thinking leads to success. In 1999, the conventional, new-era wisdom was that stocks could only go up. Investors regarded advisers recommending caution as eccentric at best - trust us, we know. As Keynes suggested, espousing an unconventional view was hard on the reputation. The ensuing severe bear market had pounded investors by the end of 2002. Investors then regarded advisers recommending an aggressive investment posture as rash, just before the subsequent bull market. Most financial firms were trying to move "product" rather than to provide advice. They advertised what was popular - being greedy at the top and fearful at the bottom. It is better for their reputations to have you fail conventionally. We know how hard all this is, and helping our clients to fight the inner war between investing reality and psychology is one of our most important services. If you would like the benefit of our experience and discipline, call us at 503-419-3938.