

Human misjudgment and its financial costs

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Michael J. Ritger

Part 1:
Common errors we all make

Part 2:
What to do about it

Part 1:

The 7 most common sources of financial misjudgment

1) Survivorship bias

Dunce or genius, bust or rich, can be the luck of the draw

Same investment plan and withdrawal rate. Only difference is retirement date.



2) Herding and familiarity bias

We feel safe taking risks in good company, and in assets that are commonly discussed.

- Stocks felt safe in '99 & '07
- Housing felt safe in '05
- Gold in '80 & '11
- Resource stocks in '07
- Bitcoin & weed stocks in '17
- FAANG, etc, etc



Reality: Manias and crashes are the norm

Bear markets happen, and they can be long



3) The narrative fallacy

We seek rational-seeming explanations for random events

“Stocks rally on break with Iran deal”

In reality, asset prices are chaotic, driven by emotion, and probabilistic, not predictable.

Let's play the chart game....

The Dow: Find Pearl Harbor





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Oil price: Where did the Gulf War start and end?



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London Stocks: Find Brexit



Volume 274,613



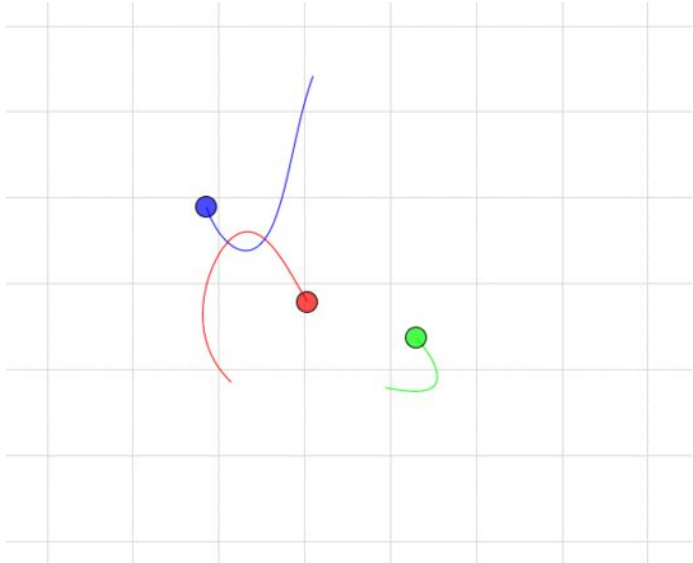
London Stocks: Find Brexit



Reality is unfathomably complex: The three body problem

Dynamic systems are unpredictable, even with only three parts.

We could not predict prices from events, even if we knew history in advance.



4) Authority and the “Halo Effect”

“My broker is E.F. Hutton, and *he* says...”



Reality: These guys can't keep *themselves* out of trouble

Failures and bailout recipients:

BEAR
STEARNS

WELLS FARGO



THE
BANK OF
NEW
YORK



Merrill Lynch



STATE STREET

citi



JPMorganChase

Bank of America



Goldman
Sachs

5) The agency or incentive problem

Never ask a barber if you need a haircut.

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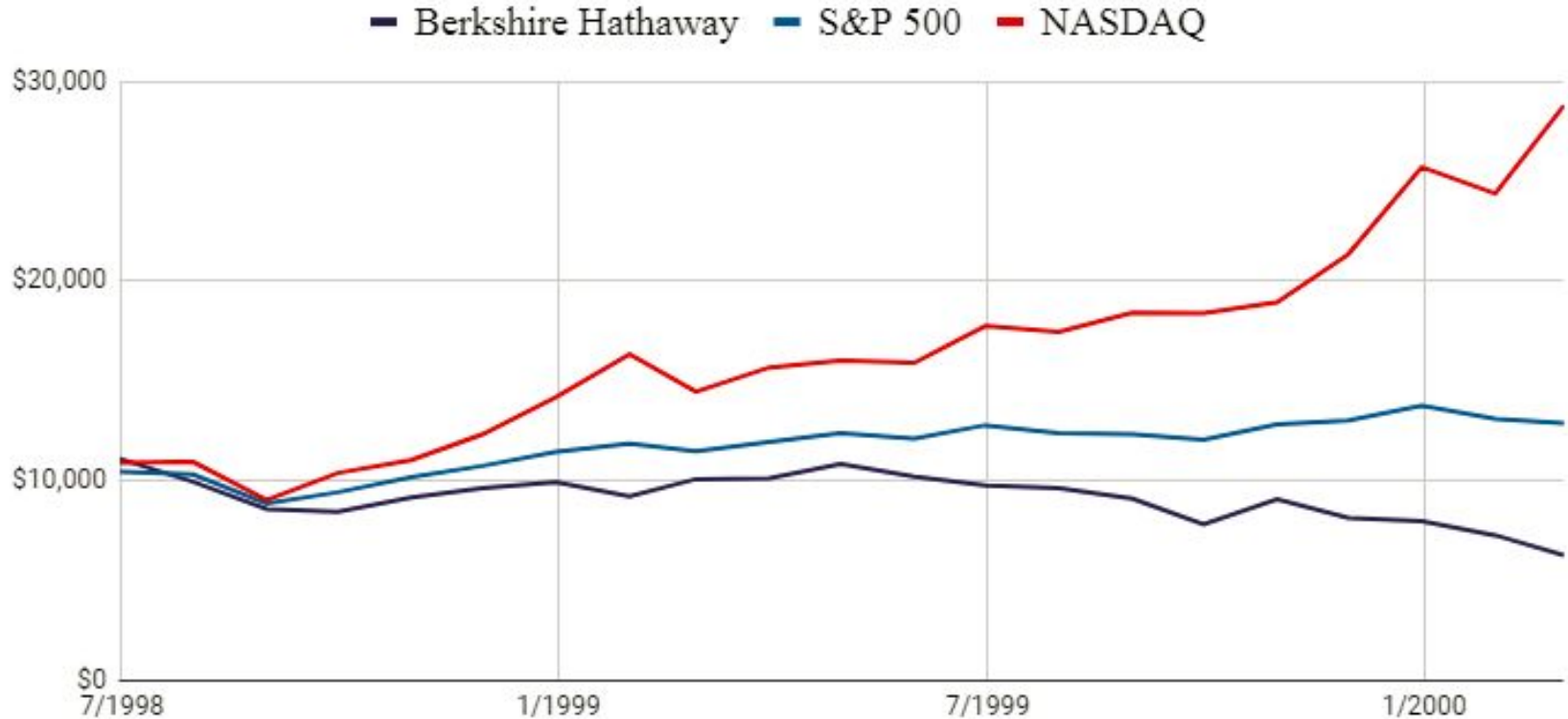
Brokers encourage trading: “churn & burn”

High-fee mutual funds, annuities, insurance products

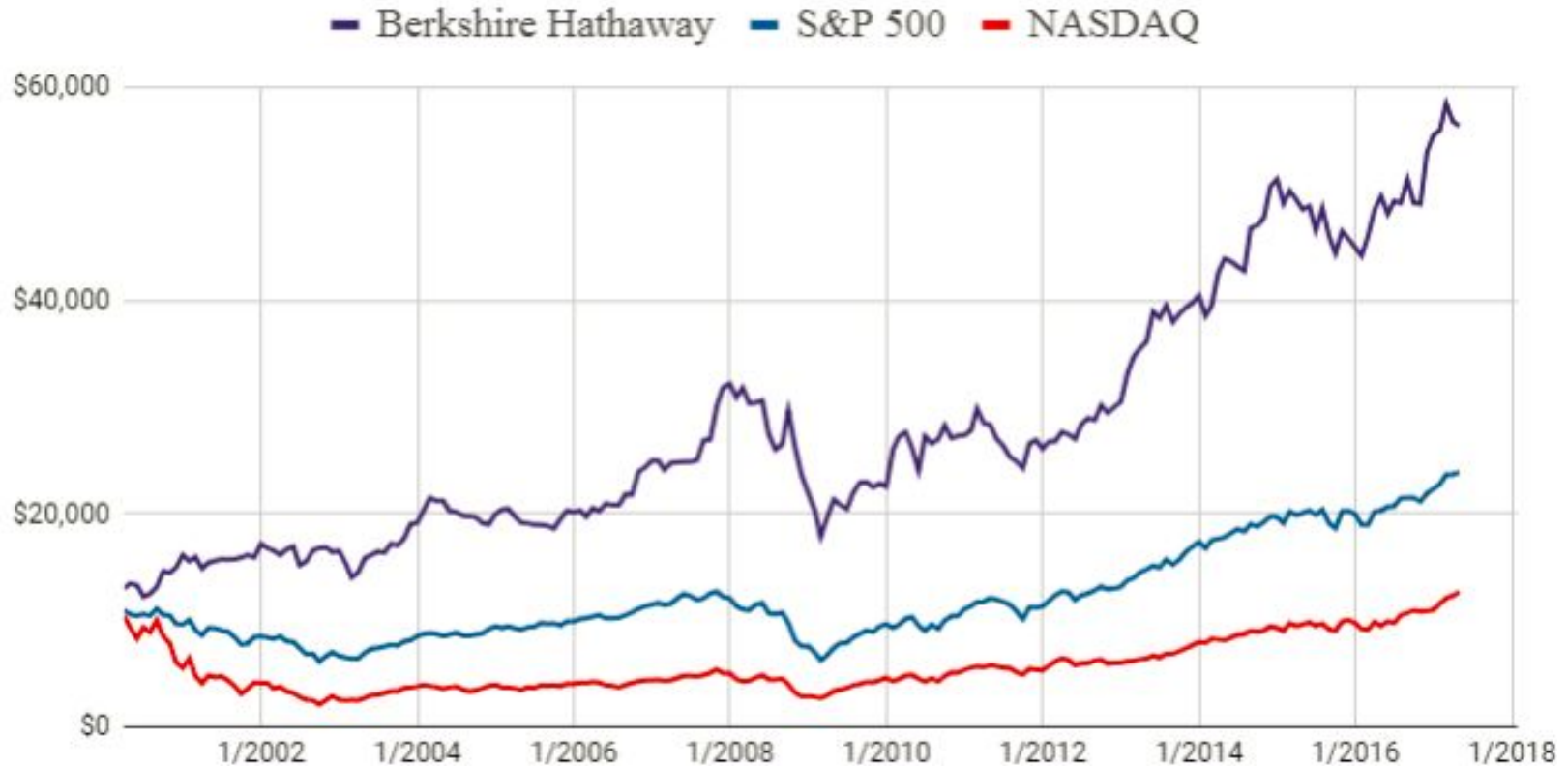
A focus on benchmark tracking risk, not real risk

6) Recency bias

Example: When Warren Buffett “lost his touch”



In reality, investors had lost perspective



7) Denial

When reality is too painful to bear people tend to ignore it.

“It's just a dip.”

“It's an even better buy now.”

Part 2

What to do?

Learn the basics so you can evaluate professionals or DIY.

Study market history and expect even worse.

Diversify by asset class.

Control the downside, not the upside.

Stay the course.

“You’ve got to work hard to get your thinking clean to make it simple.”



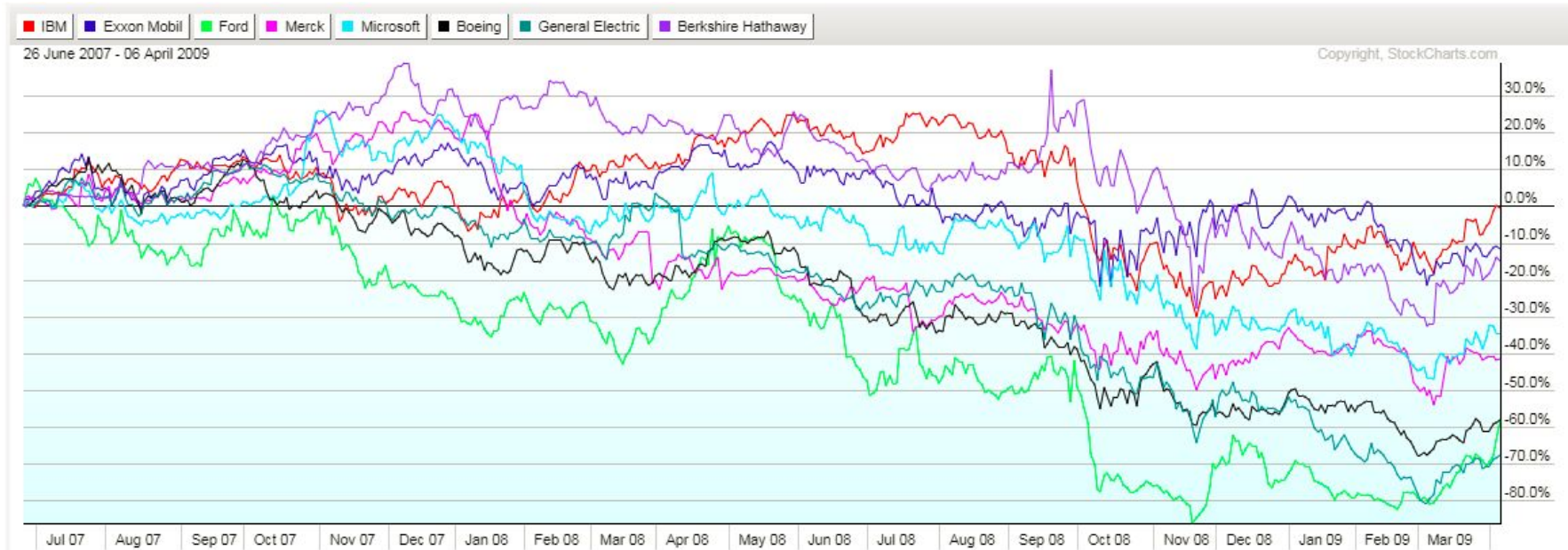
140 million years



Step 1: Diversify meaningfully

A diversified stock portfolio is not a diversified portfolio

2007 - 2009



A truly diversified portfolio holds different asset classes

2007 - 2009



ETFs make diversification simple

Low-cost asset class ETFs:

SPY - S&P 500

EFA - Foreign Stocks

TLT - US Treasury Bonds

IEF - US Treasury Notes

LQD - US Corporate Bonds

BNDX - International Bonds

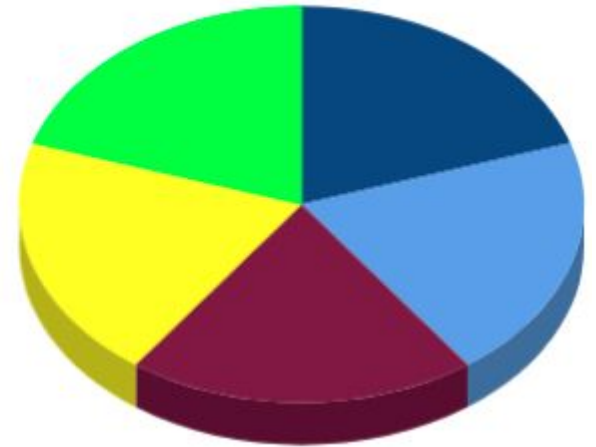
IAU - Gold

VNQ - Real Estate Investment
Trusts (REITs)

The Know-Nothing Portfolio

1 / N (“one over n”): Simple and Robust:

- S&P 500
- EAFE International Stocks
- US REITs
- Gold
- US Corporate Bonds

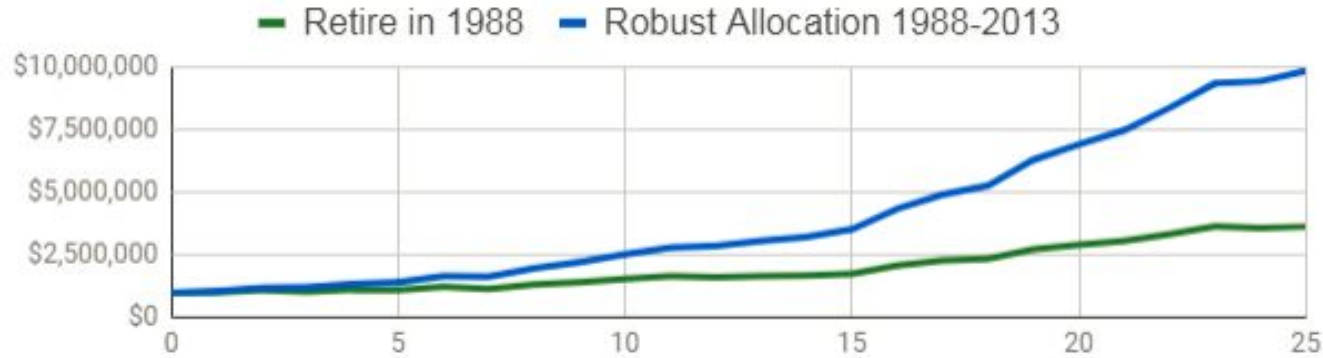


Step 2: Stop-losses are the answer to the denial problem



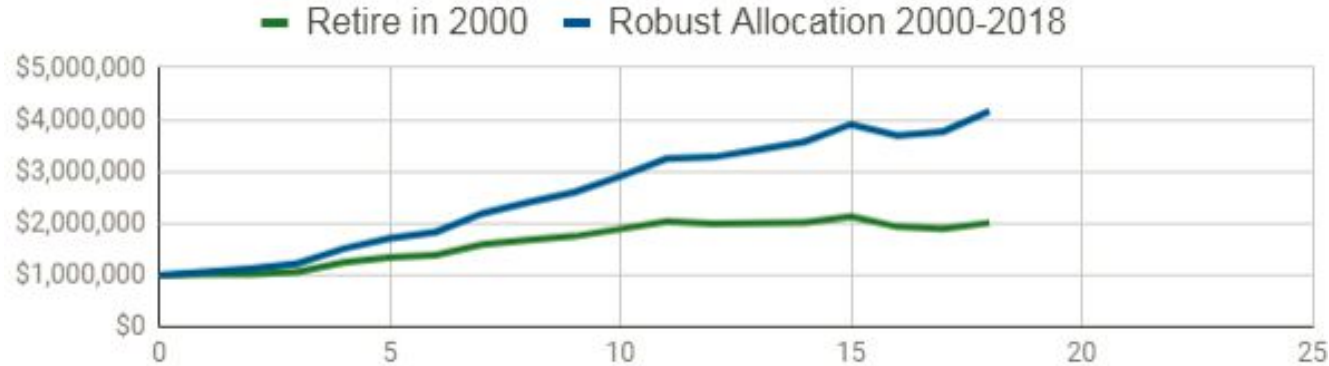
5-Asset Know-Nothing Portfolio. Returns include est. fees and are adjusted for inflation (would look much higher if not). *Stop-losses set at 12-month simple moving average, monthly basis.

The Result: Worry-free retirement



Portfolio without
withdrawals

Portfolio after
withdrawals of 5% in
first year, increasing
at rate of inflation



What's the catch?

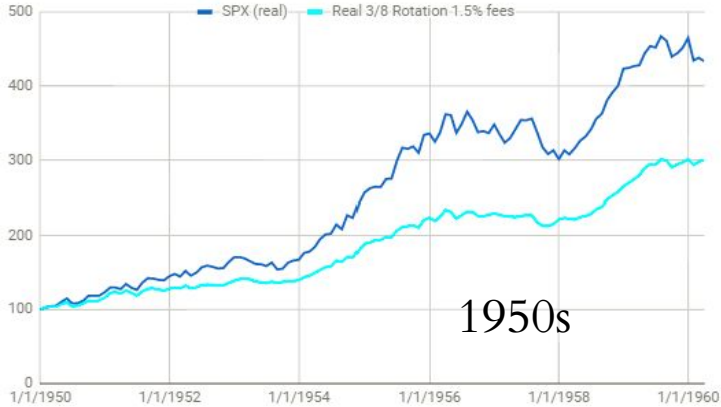
So this is awesome, but there's no free lunch on Wall Street.



“This is your pain”

This is your pain: FOMO (fear of missing out)

It's frustrating to lag the crowd (herding), even for a short while (recency bias).



1950s



1990s



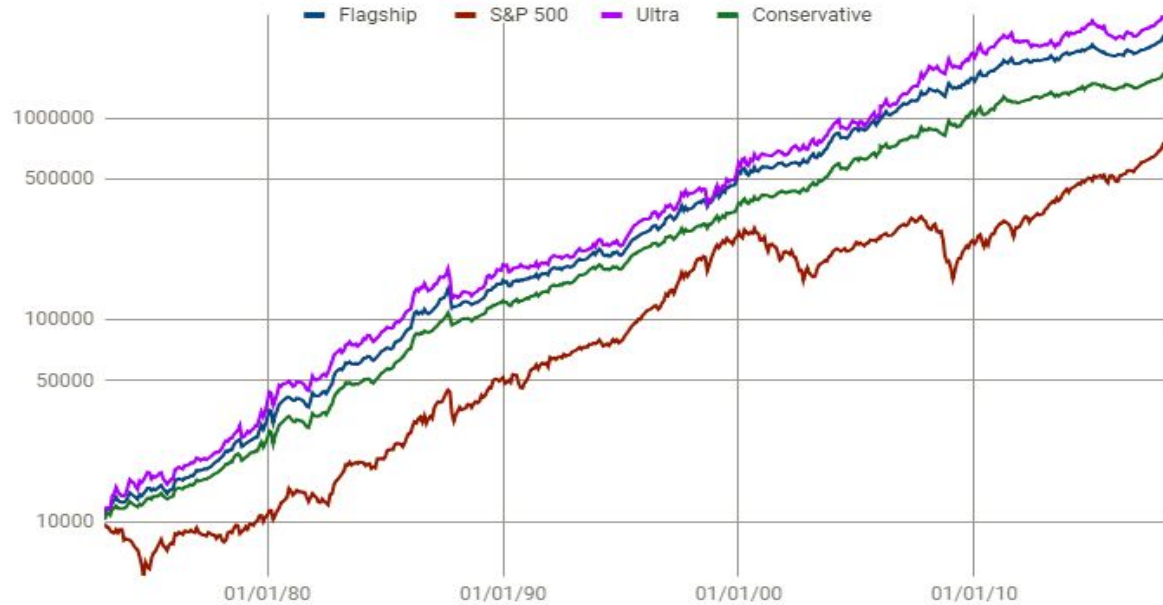
2010s

Accept the pain

Pain is the price of good returns, and *bear markets are less painful than underperforming a rising market.*

To win, you must overcome **herding** and **recency bias**.

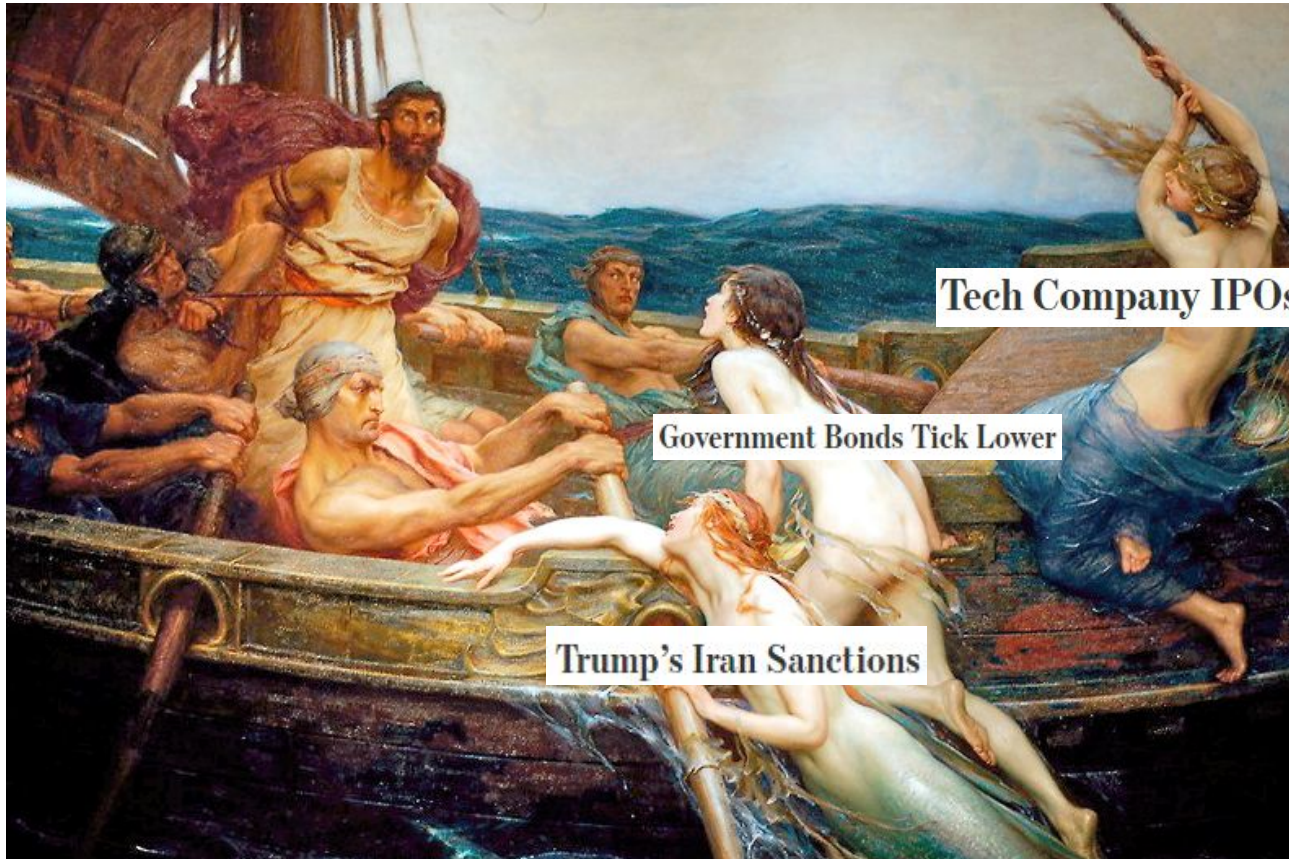
What really matters: a) Never losing a lot of money, and b) strong long-term performance



Strategy	\$10,000 becomes	CAGR	Maximum loss	Sortino ratio
Fortuna Conservative	\$1,600,000	11.85%	13.3%	1.3
Fortuna Flagship	\$2,403,000	12.85%	19.5%	1.3
Fortuna Ultra	\$3,080,000	13.47%	28.5%	1.0
S&P 500 Index Fund	\$692,000	9.80%	50.8%	0.6

See slide 36
for
disclosures.

Choose a robust strategy, then tie yourself to the mast
(or better yet put wax in your ears).



Tech Company IPOs

Government Bonds Tick Lower

Trump's Iran Sanctions

Have questions? Need to make a plan?
Get in touch:

Michael J. Ritger is a principal of and investment advisor representative for Fortuna Investors, LLC, a registered investment advisor in Miami Beach, FL, specializing in systematic asset allocation strategies for private accounts.

We offer [conservative](#), [moderate](#), and [aggressive](#) strategies, which incorporate the basic principles demonstrated in the “Know-Nothing Portfolio” described above, and are refined for the highest possible returns per level of client risk.

michaelritger.com
mjr@fortunainvestors.com
(646) 538-1949

References

For a deeper dive into these topics, see:

Charlie Munger's speech, "The Psychology of Human Misjudgment"

David Swensen, "Unconventional Success: A Fundamental Approach to Personal Investment"

Nassim Taleb, "The Black Swan," "Antifragile," and "Fooled by Randomness"

Daniel Kahneman, "Thinking Fast and Slow"

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