

PERSPECTIVE *With* JEFF SARTI

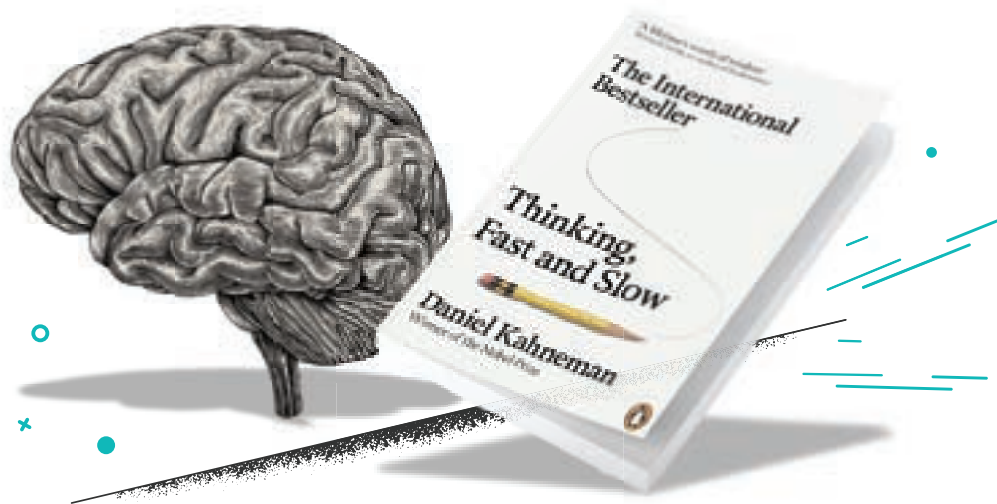


Be wary of what is familiar when investing

Human nature is hardwired to seek the familiar. Whether it's time with our loved ones, our workout routine, our favorite pair of jeans or that perfect spot on the couch, we gravitate to the familiar because it puts our mind at ease. Familiarity feels safe and therefore trustworthy. While this instinct to seek out the familiar can be beneficial in some regards, I believe it is detrimental when applied to investing. In previous editions of the *Perspective*, I've advocated pursuing the Right Mindset when it comes to growing as a Better Investor. Related to this, I believe that our innate gravitation towards familiarity reinforces the "Wrong Mindset" when it comes to sound long-term investing.

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An understanding of how familiarity biases our investment behavior starts with an explanation of why we are so drawn to



seeking out the familiar. In his preeminent book, *Thinking, Fast and Slow*, Nobel Prize-winning economist Daniel Kahneman states that “familiarity breeds liking” because it is rooted in our survival instincts. Imagine you are a prehistoric hunter, out in the wild as dusk is approaching. You are extremely familiar with the flora and fauna of the landscape, but suddenly you hear rustling in the bushes that is distinctly unfamiliar. How do you proceed? Perhaps with fear or, at the very least, a heightened sense of caution. The unfamiliar is not something to be trifled with.

Now, what happens when you hear this same rustling, in the same location, several nights in a row? The unfamiliar gradually becomes familiar and you approach the sound with less fear and more curiosity, leading you to discover a new species of rodent that can feed your family for the night. This pattern of behavior from fear to curiosity as something moves from the

unfamiliar to the familiar is valuable from an instinctual and survival point of view. But is this trait beneficial when it comes to our intellectual pursuits?

Kahneman profusely believes this trait can be harmful and biases us in error-prone directions. Numerous studies have confirmed that when individuals are repeatedly shown an unknown foreign word that the increased familiarity of it translates into increased positive feelings, regardless of the actual meaning. These positive feelings make us more likely to trust in something, whether we have any basis for that trust or not. Kahneman claims, “A reliable way to make people believe in falsehoods is frequent repetition, because familiarity is not easily distinguished from truth.” Marketers and skilled (and devious) politicians have this strategy down pat. They use strategies that center around increased exposure and repetition because they know that familiarity breeds feelings of security and trust.

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How does this relate to investing? As in other areas of life, it is hardwired into our brains to seek out investments that are familiar to us because they feel safe and therefore trustworthy. Many great investors, from Warren Buffett to Peter Lynch, have recommended that investors only invest in what they “know” or “understand.” But years after making this comment, Lynch felt as if his words of wisdom were misconstrued: “I’ve never said, ‘If you go to a mall, see a Starbucks and say it’s good coffee, you should call Fidelity brokerage and buy the stock.’” Familiarity does not equal knowledge; in fact, familiarity may give us a sense of false confidence that we understand something that is beyond our scope of expertise.

For example, many investors are naturally drawn to Disney stock. However, do they really understand the stock or are they simply investing in something familiar since Mickey Mouse is as much a part of Americana as apple pie? I propose that it would take weeks of deep work to truly understand a company as complex as Disney. While we are all familiar with its theme parks and classic movies, do we really understand Disney as a business? For example, do we understand its balance sheet and how much debt it has, the currency effects of selling its products around the globe, its internal culture and how it compensates and retains key employees? And, most importantly, its valuation – is it cheap or expensive based on a variety of different valuation metrics? After all, a great company does not necessarily make a great stock.

Let’s compare this to an investment that I believe many investors can understand. Think about the analysis required to invest in an apartment building. Though by no means easy, there are a limited amount of factors

that investors can and should consider when deciding whether to invest in a particular building. For example, you would look at the rents being collected, the vacancies, the operating and utility costs, and the supply of other apartments within a few-mile radius. Most reasonably sophisticated investors could review a variety of data points to determine if it’s a good buy or not. While by no means rare, apartment buildings are a lot less accessible to average investors (as opposed to Disney stock, which anyone can buy with a click of a button). We believe that less familiar investments can be more attractive simply on the basis that less crowding means a lower price and therefore less risk.

Your next thought may be, “Sounds great, but I don’t have the net worth to invest in an apartment building.” A fair concern, but another example about how lack of familiarity may steer you to the wrong conclusion. There are actually many ways to invest in apartment buildings, from fairly conservative (as a lender) to more

aggressive (as an owner), from a focus on immediate cash flow versus an emphasis on long-term growth, to ranges of liquidity (from daily to quarterly to long term) depending on your risk profile and liquidity constraints. An understanding of these structural differences is not rocket science, but most investors avoid these opportunities simply because they are unfamiliar. It’s our job to demystify the unfamiliar and educate you on the opportunities that are best suited for your portfolio.

At Morton Wealth, we seek true understanding of the investments we make as opposed to settling for what is simply familiar. We believe seeking out the unfamiliar is a rare approach that sets us apart from others in terms of finding attractive investment opportunities. Familiarity is a wonderful quality that allows us great comfort in our daily lives and surroundings; however, in the intellectual pursuit of growing as a disciplined Better Investor, be cautious with what feels familiar and focus on true knowledge and understanding. ■



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