

# Investing in turbulent times

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# Agenda

- **Current environment**
- **The biases of the human brain**
- **Investment strategies**

# Stocks down

**SPX** ↑ **968.75** +14.66 m  
 At 16:28 Op 953.11 Hi 984.38 Lo 944.59 Prev 954.09

Index **GPO**

SPX INDEX Hide GP - Line Chart Page 1/41

Range 11/06/98 - 10/31/08 Upper Line Chart  Mov. Avgs  Currency USD

Period Weekly  Lower None  Mov. Avg 15  Events



Dec 25 1998 Dec 31 1999 Dec 29 2000 Dec 28 2001 Dec 27 2002 Dec 26 2003 Dec 31 2004 Dec 30 2005 Dec 29 2006 Dec 28 2007 Dec 26 2008

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000

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# On the madness of mobs

**The mass never comes up to the standard of its best member, but on the contrary degrades itself to a level with the lowest.**

**- Henry David Thoreau**



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# Fear is palpable

**VIX** ↑62.90 -7.06

Index **GPO**

At 16:14 Op 69.83 Hi 69.83 Lo 62.67

VIX INDEX Hide GP - Line Chart Page 1/42

Range 10/02/98 - 10/24/08 Upper Line Chart  Mov. Avgs  Currency USD   
Period Weekly  Lower None  Mov. Avg 15  Events

Last Price	79.13
High on 10/24/08	79.13
Average	20.74
Low on 02/16/07	10.02



Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2008 Bloomberg Finance L.P.  
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# Black swans

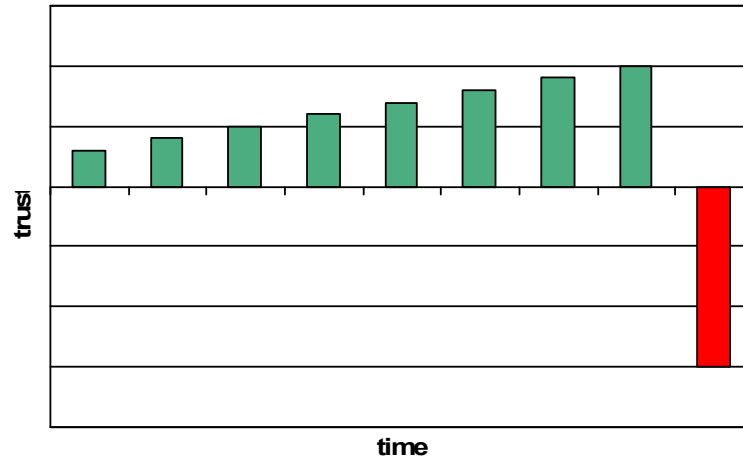
- **An event with a massive impact**
- **Unpredictable in advance**
- **Explanation only obvious in hindsight**



Nassim Nicholas Taleb, *The Black Swan*, 2007

# Characteristics of black swans

## Well-being of a turkey



The tricks our  
brains play on us



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# Fear and greed



# Visual cues elevate fear



# Behavioral finance

**...a recognition that people don't always do what economic models assume they will.**



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# Cognitive biases

- **Overconfidence**
  - success results from skill and misfortune stems from “bad luck”
  - think we know more than we do
  - think we have control over more than we do

# Overconfidence

<b>Question</b>	<b>Answer</b>	<b>%</b>
<b>Weight of Statue of Liberty</b>	<b>225 tons</b>	
<b>Yale endowment</b>	<b>\$22.5 b</b>	
<b>Pulitzer prize award</b>	<b>\$10,000</b>	
<b>US population in 1790</b>	<b>3.893 mil</b>	
<b>Land area of Ohio</b>	<b>40,948 sq</b>	

# Behavioral biases

- **Prospect theory**
  - Our position determines our risk preferences
  - People tend to be risk loving when attempting to escape a sure loss



Kahneman and Tversky, *Econometrica*, 1979

# Prospect theory

	<b>Prob</b>	<b>Payoff</b>	<b>E(x)</b>	<b>%</b>	
<b>1A</b>	<b>100%</b>	<b>\$1,000</b>	<b>\$1,000</b>		<b>Risk aversion</b>
<b>1B</b>	<b>50%</b>	<b>\$2,500</b>	<b>\$1,250</b>		
<b>2A</b>	<b>100%</b>	<b>-\$1,000</b>	<b>-\$1,000</b>		
<b>2B</b>	<b>50%</b>	<b>-\$2,500</b>	<b>-\$1,250</b>		<b>Risk Seeking</b>

# Behavioral biases

- **Anchoring**
  - Everything is relative
  - e.g., the price we purchased a stock at serves as an anchor against which we measure success



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# Anchoring

## Price of the chocolates

<b>Floors 1-6</b>	<b>Floors 7-11</b>	<b>Floors 12-16</b>	<b>Floors 17-21</b>

# Other behavioral biases

- **Regret avoidance**
  - Avoid selling stocks that have declined, but rush to sell “winners”
- **Cognitive dissonance**
  - Mental conflict when one realizes one’s beliefs are incorrect
- **Wishful thinking**
- **Representativeness heuristic**
  - Choose an item by its similarity to familiar types (e.g., “blue chip” stocks)

Is history helpful?

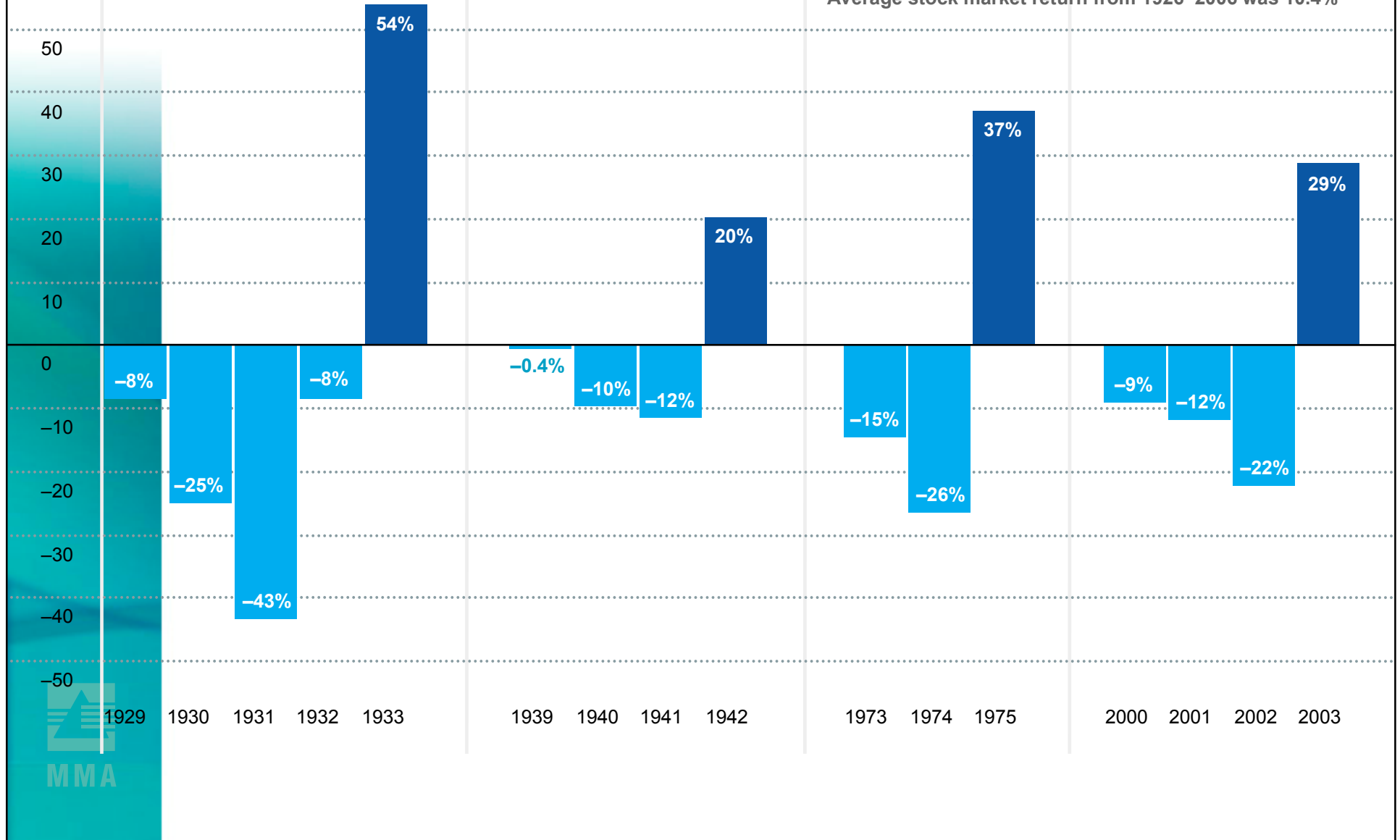


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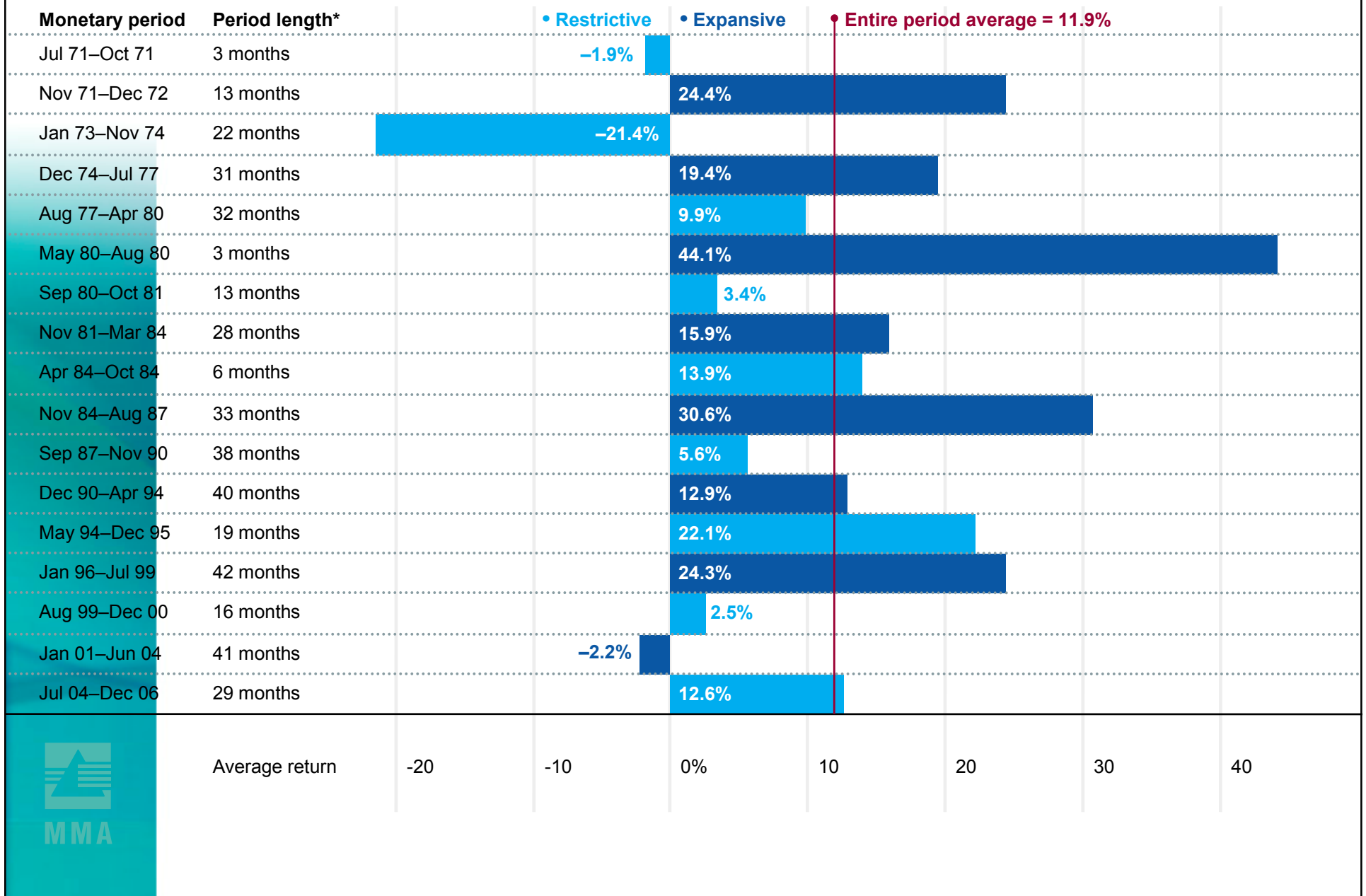
# Periods of Consecutive Negative Stock Returns

60% Return

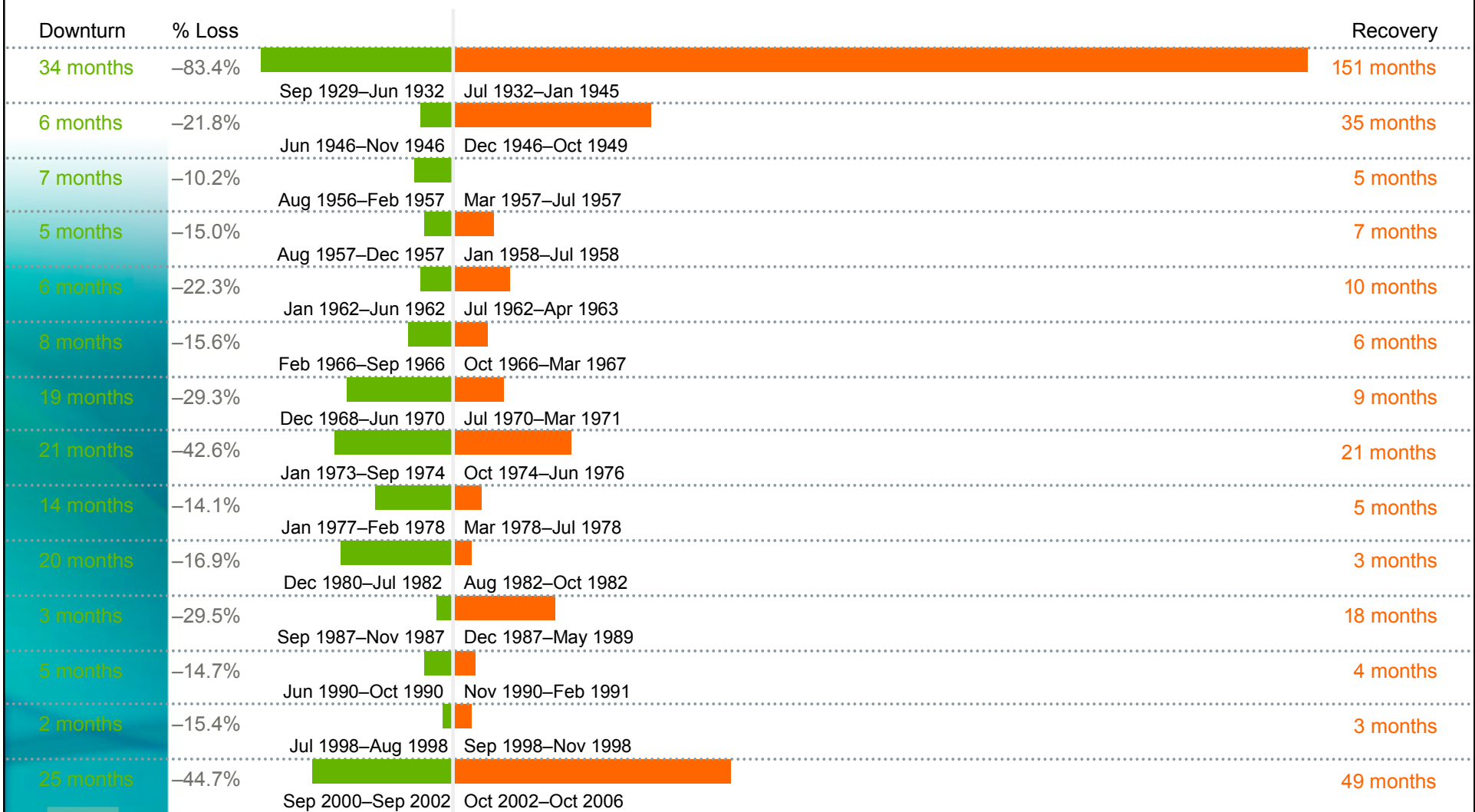
Average stock market return from 1926–2006 was 10.4%



# Stock Returns and Monetary Policy



# Downturns and Recoveries 1926–2006



# Strategies for investing in good times and bad

- **Make a thoughtful plan and stick to it**
- **Diversify**
- **Invest on a schedule: don't deviate**
- **Pay attention to your emotions**
- **Don't watch...at least not too often**



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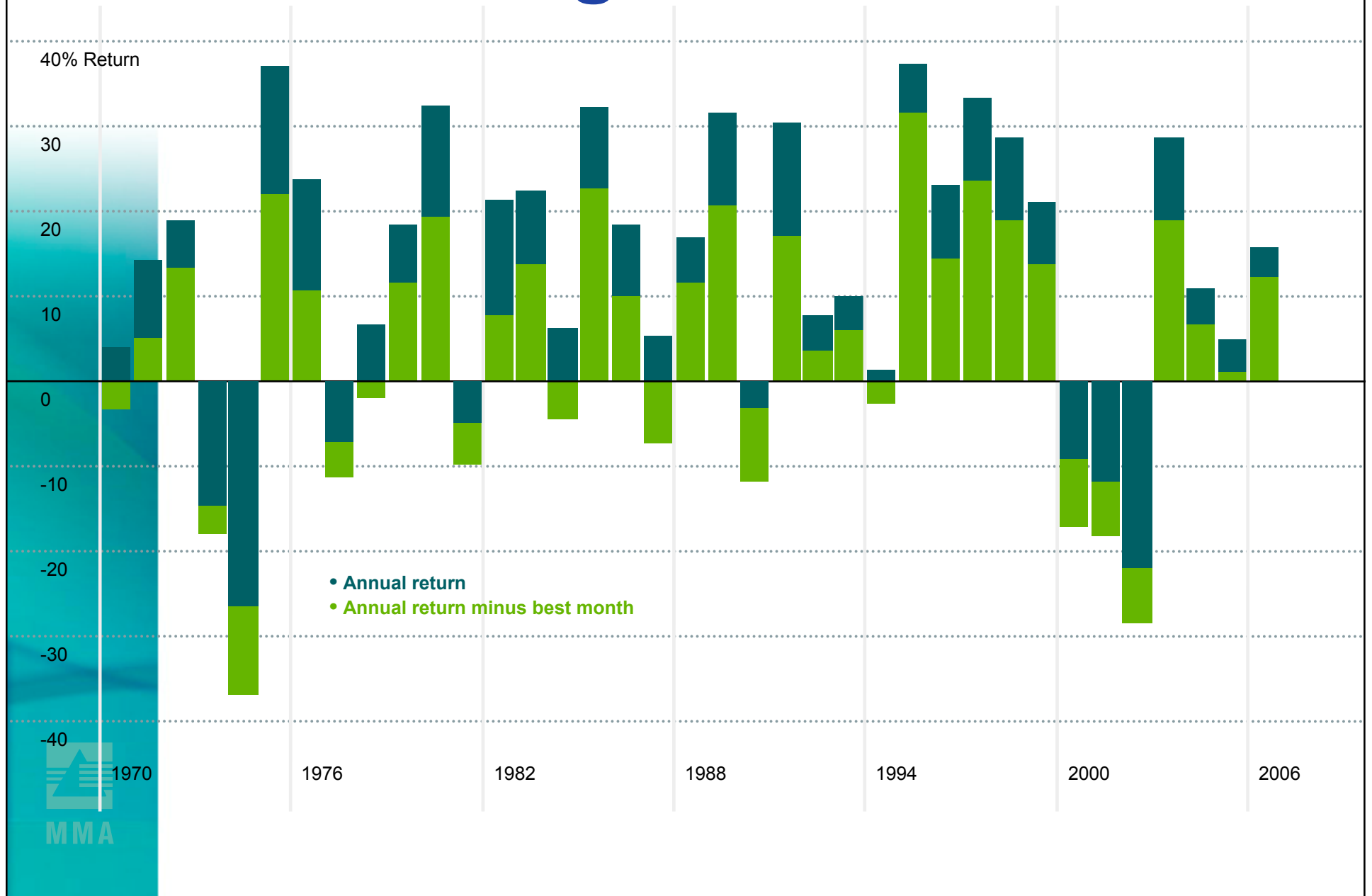
# More strategies

- **Be humble: black swans will appear**
- **Don't base investment decisions on statements like "everybody knows that..."**
- **Rebalance**
- **Don't attempt to time the market**



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# Market-Timing Risk



# Going against the crowd

**The greatest man is he who in the midst of the crowd keeps with perfect sweetness the independence of solitude.**

**- Ralph Waldo Emerson**



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