THE TURTLE'S TAKE

On The Invisible Gorilla

ARIEL INVESTMENTS

At Ariel we strive to improve continually as investors. We are vigilant readers, always seeking to bolster our core beliefs or productively disrupt ingrained assumptions.

We also welcome thought leaders and fellow travelers to discuss investing and related topics. In the last three years, for instance, we have welcomed *The Black Swan* author Nassim Taleb, *Wall Street Journal* columnist Jason Zweig and *Deep Survival* author Laurence Gonzales to meet with us. Recently Michael Mauboussin, Chief Investment Strategist at Legg Mason Capital and author of *Think Twice,* came to discuss his most recent insights. This visit turned out to be a two-for-one event, because not only was his presentation thought-provoking and helpful, but he also recommended *The Invisible Gorilla* by Christopher Chabris and Daniel Simons. We found this book fascinating and broadly applicable. We not only used it as the grounds to think of different ways its teachings apply to our stock-picking and portfolio construction, we also believe it holds valuable lessons for financial advisors. After you read this piece, we think you will want to buy your own copy.

The title of the book comes from a famous, provocative experiment Chabris and Simons ran to sharply challenge prevailing notions of human beings' observational abilities. For those of you unfamiliar with the experiment, we won't spoil the surprise; you can witness it yourself at theinvisiblegorilla.com/videos.html. This book studies six everyday illusions that "make us think that our mental abilities and capacities are greater than they actually are" because "we confuse how easily our minds can do something with how well they are doing it" (229-230). Some examples of these illusions are essentially urban legends: people only use 10% of their brainpower; listening to Mozart makes babies smarter. Others are common behaviors where we overshoot our abilities, such as when we talk on the phone while driving or "multi-task" at our desks. Below we summarize the book and thereafter discuss our big takeaways for financial advisors.

The six everyday illusions *The Invisible Gorilla* identifies are the illusions of attention, memory, confidence, knowledge, cause and potential. The illusion of attention refers to our collective belief we pay closer attention than we actually do and that by concentrating we can "lift" our level of attention. Actually, even when we focus intently, our perception and retention are far more limited than we think. Also, a person's attention is zero-sum: "the more attention-demanding tasks your brain does, the worse it does each one" (24). There are two components to the illusion of memory: we wrongly think our ability to remember events and context is powerful; we assume the more clear the memory, the more accurate it is. Actually, our memories are remarkably fallible in multiple ways, and the connection between a memory's clarity and accuracy is much weaker than most people think. The illusion of confidence holds simply that self-assurance reflects ability. The truth is: confident people project their self-esteem broadly, not just toward areas of real expertise. The illusion of knowledge is also straightforward: we generally think we know more than we do. Three interlinked biases compose the illusion of cause: "our minds are built to detect meaning in patterns, to infer causal relationships from coincidences, and to believe that earlier events cause later ones" (153). Lastly, the illusion of potential occurs when we think we can become vastly better at something with relatively little effort. From this misunderstanding come the beliefs that Sudoku makes you better at reasoning, classical music sharpens your brain and so forth.

We believe the overall impact of these illusions is deep and profound for financial advisors. As we discuss below, *these everyday illusions drive smart, rational people to be poor investors.* Oftentimes when our industry discusses the advisor's craft, we focus on information. Financial advisors help create a prudent and robust long-term plan, educate clients when unsettling market events (the 2007-2009 bear market; the May 2010 "flash crash") occur and manage expectations about how investments are likely to behave long-term. These are all critical activities where you communicate professional, financial expertise to your clients, who often lack the knowledge they need to make sound decisions. We propose that sometimes it also makes sense to view your job from a completely different angle: poor financial decisions often come not from a lack of information but due to an overabundance of intuition. The everyday illusions detailed above drive people to make poor choices on impulse—whether they have knowledge and access to information or not.

The illusion of knowledge and investing

One experiment detailed in *The Invisible Gorilla* is directly linked to the financial advisor's profession, and it dramatically proves that information overload makes us worse investors. Most people believe the more information they have, the better the decision they will make. In fact, the opposite can be true. Richard Thaler held an experiment to invest a hypothetical college endowment between two portfolios, A and B, using an artificial financial market and simulated time period of 25 years. He divided the test subjects into three groups: one received *monthly* performance updates, one *yearly* reports and a third only saw returns every five years. The participants were allowed to reallocate with each update. "By the end of the experiment, subjects who only received performance information once every five years earned *more than twice as much* as those who got monthly feedback" (135).

By no means would we suggest taking the results literally: do not abandon quarterly or annual updates. Rather, we believe the larger point—as appears in other behavioral studies—is that when presented with lots of information of varying importance, we can make flawed decisions based on patterns that may be illusions. Encourage your clients not to track daily results or even weekly results if possible. Moreover, search for signs that clients are attempting to drink from a fire hydrant. Are they able to quote S&P 500 and Dow levels with precision? Do they focus intently on the quarterly results of individual holdings in a portfolio? Do they quote back the suggested trades from high-energy television experts? When dealing with clients enduring such hang-ups, encourage them to focus on the overall plan, how it is supposed to behave over the long-term, and on the longest time periods available. You might even take the opportunity to explain Thaler's experiment and his findings. Finally, take a look back at your own client communication pieces to make sure that you consistently and prominently stress the long-term over the short-term and strive to do so going forward.

The illusion of cause and investing

The most straightforward implication of the illusion of cause is familiar to all investment professionals: performance-chasing. While we often chalk this tendency up to ignorance, human beings are hard-wired to chase performance. As Chabris and Simons put it, "our minds are built to detect meaning in patterns" (153). And when a human being sees a chart or table of a type of investment going up over a multi-month or multi-year period, the intuitive expectation is it will continue to do so, and vice-versa. This innate attraction to charts that *seem* to project future wealth helps explain the Internet bubble in 1999-2000, the recent housing bubble, and—we think—the recent craze for bonds. Similarly, the inverse explains the distaste for value investing in the late 1990s and the recent hatred of developed market equities.

Investing is rife with examples of the illusion of cause. Most notably, any clients attracted to "technicals," such as trendlines, "head-and-shoulders formations," and so forth suffer from this illusion. Those making prognostications on market levels six, twelve, or eighteen months out—as well as those asking for them—are likely under its influence. Finally, clients drawn to recent chart-toppers, whether individual stocks, sectors, or entire asset classes, may well be making this mistake. To our minds, the best rejoinder to such performance-chasing is the simple concept of reversion to the mean. The more out-of-line an asset class, category, or individual investment is from its historical average or other assets, the more likely it is to reverse course at some point. We would note domestic equities have recently been on the opposite side of the mean-reverting coin: with the S&P 500 in negative territory for the last decade, we believe it becomes increasingly likely it will revert to its long-term upward trend rather than extend its fall.

The illusion of confidence and investing

We noted above one core finding about the illusion of confidence, and its implications may be obvious. That said, we believe the most critical lesson concerning overconfidence in *The Invisible Gorilla* is more nuanced than the suggestion that it is dangerous. The point comes from a study of individuals' senses of humor (which indeed can be quantified, it turns out!):

> The average student is, by definition, better than 50 percent of other students. But 66 percent of the subjects thought they had a better sense of humor than most of their peers. Where did that sixteen-percentage-point overconfidence effect come from? Almost exclusively from those participants with the worst sense of humor! People who scored in the lowest 25 percent on the sense-of-humor test thought they had an above-average sense of humor (88-89).

Thus, we suggest you not worry about modest or typical overconfidence. Rather, seek the most extreme examples of poor investing behavior among clients and prospects.

A number of solutions are already in use for thousands of financial advisors when dealing with such clients. Chabris and Simons note a key reason for overconfidence comes when people do not receive feedback on their lack of skill. One possible avenue, therefore, is to allow very overconfident clients to maintain small "trading accounts," in which they can see their results. On the other hand, some advisors take the tough-love step of "firing" such difficult clients. You probably already have developed a good way to deal with such clients; we believe the book's impact helps to identify those most likely to be making the worst decisions.

Chabris, Christopher and Daniel Simons. *The Invisible Gorilla.* New York: Crown, 2010. www.theinvisiblegorilla.com

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