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F O C U S

A B r a n d e s P u b l i c a t i o n

**Behavioral Finance**

Value Investing and the Importance  
of an Investment Process

■ *“To enjoy a reasonable chance for continued better than average results, the investor must follow policies which are (1) inherently sound and promising, and (2) are not popular in Wall Street.”<sup>1</sup>*

– Benjamin Graham

While sitting in a traffic jam, maybe you’ve thought, “It took me 30 minutes to go one mile. At this pace, I’ll get home tomorrow afternoon.” Or perhaps, while playing golf, you made a birdie putt on the 13th hole and thought, “If I keep this up, I’ll shoot a 33 on the back nine!”

These are examples of extrapolation – basing a longer-term forecast on an emotional reaction to short-term developments.

Interesting, perhaps. But what does it have to do with investing?

Extrapolation is one example of many systematic errors of judgment that impede our daily decision-making. Psychologists have studied these “biases” for decades to better understand human behavior. Studies of these biases among *investors* have led to the development of the field we now call behavioral finance.

Despite theories that markets are efficient and investors consistently make logical decisions, proponents of behavioral finance contend that investors make decisions that include psychological biases, generally without realizing they’re doing so. These biased decisions can contribute to the short-term irrationality of stock prices – which value investors consider an important source of opportunity. But investors can only take advantage of these opportunities if they are able to resist the biases influencing others. That means investors must be aware of these influences and must set up and follow an investment process that is designed to counter them.

### THE DANGERS OF EXTRAPOLATION

There are a variety of behavioral tendencies that may contribute to poor investment decisions. Let’s look at one, extrapolation, in some detail.

Like the examples of being stuck in traffic or playing golf cited above, many market participants often look at negative short-term results and think, “If this continues, I’ll lose all my money in three weeks.” Or if performance is good, they may say, “At this rate, I’ll quadruple my money in six months!” From the tulip bulb craze in Holland during the 17th century to the Internet stock

bubble, history is full of examples of the dangerous effects of extrapolation. But the results are rarely as good, or as bad, as we initially envision. We often set ourselves up for disappointment or surprises when reality differs from our expectations. It’s a quirk of human nature – and one that consistently has surfaced in the investment industry.

For example, Wall Street analysts often project sales, earnings, stock prices, and other statistics too far into the future, despite evidence that these quantities are inherently difficult to predict. Near the peak of the technology stock boom in early 2000, an analyst at a major Wall Street firm predicted the stock price for a telecom company would climb to \$250 from its then-current price of around \$125. (Both prices have been adjusted for a subsequent stock split.) The analyst based his prediction on the extrapolation of cell phone sales over 20 years. The stock price didn’t climb to \$250, as predicted. After rising to \$150 in early 2000, it fell below \$30 in 2002.

Value investors recognize tendencies such as extrapolation and establish *pre-determined* processes based on objective analysis to guide their investment decisions. An understanding of behavioral finance can help value investors capitalize on these human foibles and achieve competitive long-term returns.

### VALUE INVESTING: EXPLOITING MARKET BEHAVIOR

Look at the lines in Exhibit 1 (below). Which horizontal line is longer? Look closely. Things are not always what they appear to be. As shown in Exhibit 2 (next page), the lines actually are equal in length. These illustrations underscore a key point for value investors: you cannot always trust your perceptions. Diligence and skepticism are essential. And most important in this context, value investors need tools and rules to help distinguish opportunity from empty promises.

Exhibit 1: The Dangers of Framing

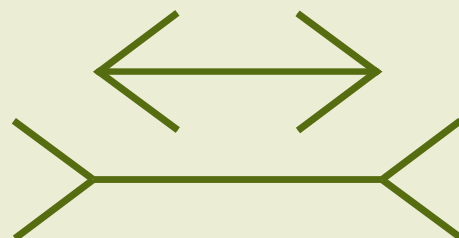
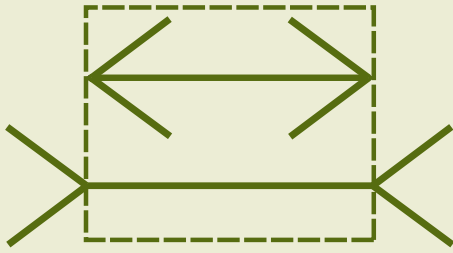


Exhibit 2: Objective Analysis vs. Perception



Think of the lines in Exhibit 1 as stocks in which you could invest. Think of your eyesight as the evaluation tool most investors use when analyzing stocks. Then think of a ruler as your value investment discipline. By applying a disciplined approach to evaluating opportunities, you limit guesswork, emotional influence, or cognitive errors. You force yourself to trust objective analysis – not your emotions, the opinions of others, or what appears to be a good opportunity. The goal is to make more informed decisions based on facts.

Benjamin Graham, widely considered to be the father of value investing, stated that following sound policies (investing in promising businesses) wasn't enough to achieve better-than-average results. As noted in the quotation that opens this piece, investors *also* must do what is not popular. In short, they must resist the temptation to follow the crowd. Value investors realize that achieving better-than-average returns depends upon thinking and acting *differently* than the average investor.

Applying behavioral finance to investing is not easy. Graham also wrote, "To achieve *satisfactory* investment results is easier than most people realize; to achieve *superior* results is harder than it looks."<sup>2</sup>

The temptations of human behavior are well ingrained in all of us. They are difficult to keep in check. Next, we examine some specific approaches designed to help maintain a value discipline and make the market's behavioral quirks work for you.

### ESTABLISHING AND MAINTAINING YOUR DISCIPLINE

"Know thyself."

Although Socrates probably wasn't talking about global stock markets when he shared this advice around 400 BC, his words are particularly relevant for investors.

As previously discussed, humans have inherent biases and tendencies to act irrationally. Graham wrote, ". . . the investor's chief problem – and even his worst enemy – is likely to be himself."<sup>3</sup> How can we protect ourselves from ourselves? Following Socrates' advice, it's vital to better understand who we are.

For starters, think back to the technology stock boom of the late '90s. Did you have money invested in stocks at that time? If so, how did you feel? And more importantly, what did you *do*? One of the most important questions you can ask yourself is: Looking back on how I've managed my money, what have I learned about myself? How do I *really* respond when stock prices rise or fall? Is it different than how I *thought* I would respond?

To gain clearer insight on what motivates you, you may wish to complete a few online tests designed to assess your investment profile. Use key words such as "risk tolerance quiz" or "risk tolerance profile" in your search. Keep in mind that the objective is to help you gain a better understanding of yourself so you can build the necessary defenses against your own potentially self-defeating tendencies.

### STAYING THE COURSE

For individuals who want to stick to a disciplined value investing approach, we offer three suggestions:

1. Write it down
2. Pause to reflect
3. Work with a professional

#### Write it Down

Individual investors may benefit from developing an investment policy statement (IPS), a detailed plan that outlines specific objectives. It may include guidelines for asset allocation, time horizons for investment, and how an individual may work with a financial advisor. Regardless of the level of detail, the IPS should help:

- Set realistic objectives
- Outline an asset allocation strategy
- Establish procedures for portfolio management

Setting long-term objectives can help avoid the tendency to focus on short-term returns. With respect to developing an asset allocation strategy, a financial advisor may suggest balancing long-term goals with short-term needs while considering your tolerance for volatility. When it comes to procedures for managing the portfolio,

including specific, step-by-step guides for purchasing or selling shares or rebalancing, an IPS can be beneficial. Having a written plan can greatly reduce the potential for making emotional decisions and can be an excellent defense against the kinds of psychological pitfalls addressed here.

- *Working with a professional financial advisor can be helpful for a variety of reasons.*

As for reviewing progress toward goals, a written plan also can help establish how often this will be done. You may want to reexamine your portfolio every six months or once a year. We suggest putting a lot of time into developing a plan and far less time into tinkering with it.

### Pause to Reflect

Often, we tend to get swept up in our day-to-day activities. Responsibilities for work, family, and friends may divert our attention from longer-term goals we have set for ourselves or the people we care about. It may be beneficial for investors to pause periodically – either alone, with a spouse or family members, or with a financial professional – to reflect on their investment approach and review goals and the plan for achieving them. In addition to reevaluating goals, we invite you to refresh your conviction for the value approach periodically and suggest reading a chapter or two from Benjamin Graham’s *The Intelligent Investor* at least once each year. The goal of such reflection is not necessarily to learn new concepts, but to fortify defenses against making irrational investment decisions. From *The Intelligent Investor*, we highly recommend Chapter 8, “The Investor and Market Fluctuations,” and Chapter 20, “‘Margin of Safety’ as the Central Concept of Investment.”

### Work with a Professional

Managing a value investment program requires considerable time, experience, hard work, and attention to detail. Individuals can and do succeed in managing their own money, given proper training and experience. But in many cases, the skills of a non-financial professional do not necessarily translate to portfolio management. In other words, the specialized skills that build wealth in one profession are not necessarily the same as those needed for successful investing. Because of the highly specialized nature of portfolio management, many investors might do well to consider the services of a professional financial advisor.

Working with a professional financial advisor can be helpful for a variety of reasons. A frank discussion with an advisor can help detect areas of weakness, check unrealistic expectations, or counter misperceptions that could be frustrating and costly. In addition to partnering with you to combat your behavioral biases, an advisor can help create a roadmap designed to lead you toward your financial goals, provide guidance on various topics, and refer you to knowledgeable professionals in related fields such as tax or estate planning, accounting, or law.

### CONCLUSION

Value investing is not easy. It is not glamorous. We believe, however, that it is an effective method for identifying solid investment opportunities. When coupled with the application of disciplined processes in undisciplined markets, value investors can transform the human foibles described by behavioral finance into successes over the long term.

1 Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel*. Fourth Revised Edition. New York: Harper & Row. 1973 (page 13)

2 Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel*. Fourth Revised Edition. New York: Harper & Row. 1973. (page 287)

3 Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel*. Fourth Revised Edition. New York: Harper & Row. 1973. (page xv)

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