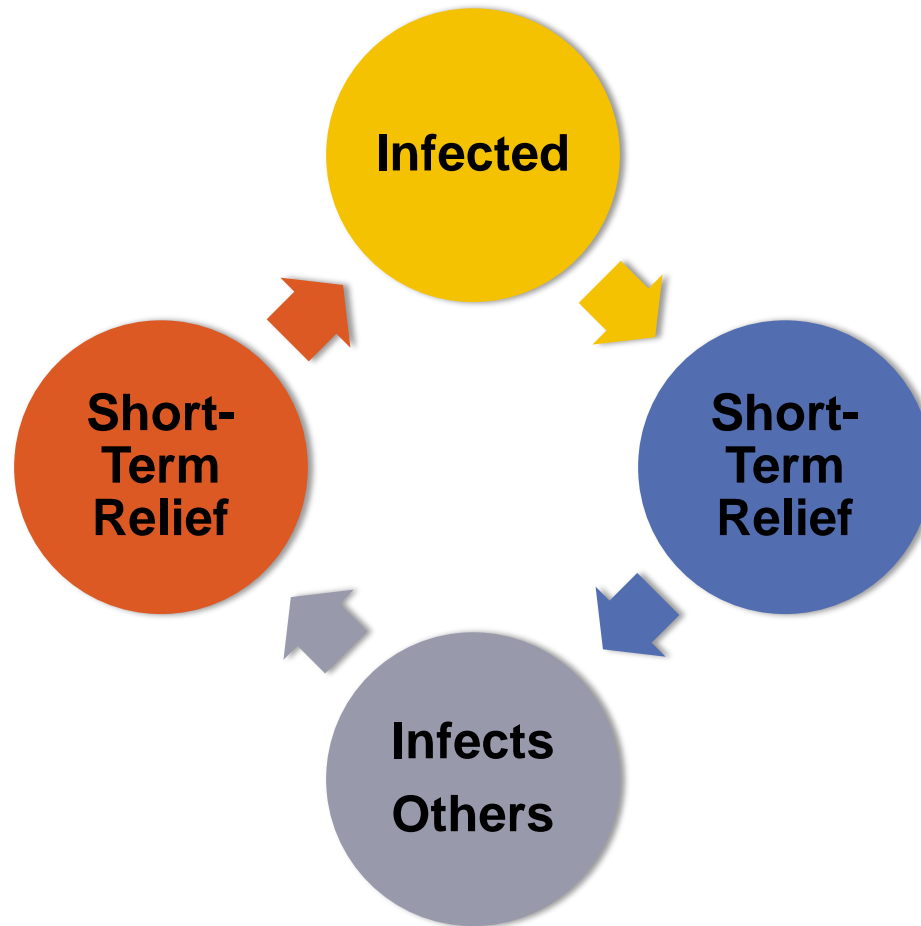


STUPID, LAZY AND RICH
OR: HOW I LEARNED TO
STOP WORRYING AND
CAPTURE BEHAVIORAL
ALPHA

OF GUINEA WORMS AND BIG RETURNS



Guinea Worm

DISEASE HAS DECREASED FROM

3.5 million
cases in 1986



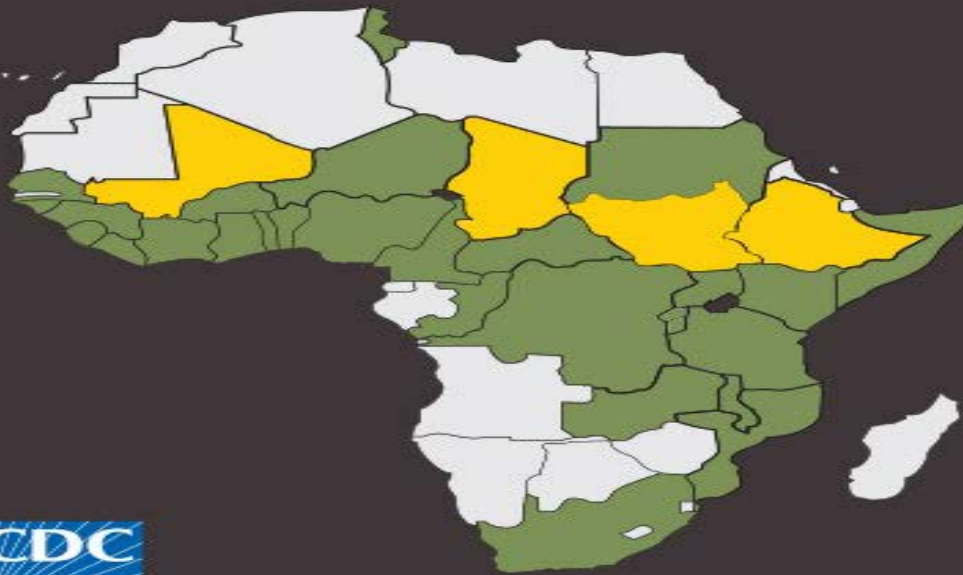
542
cases in
2012



148
cases in
2013



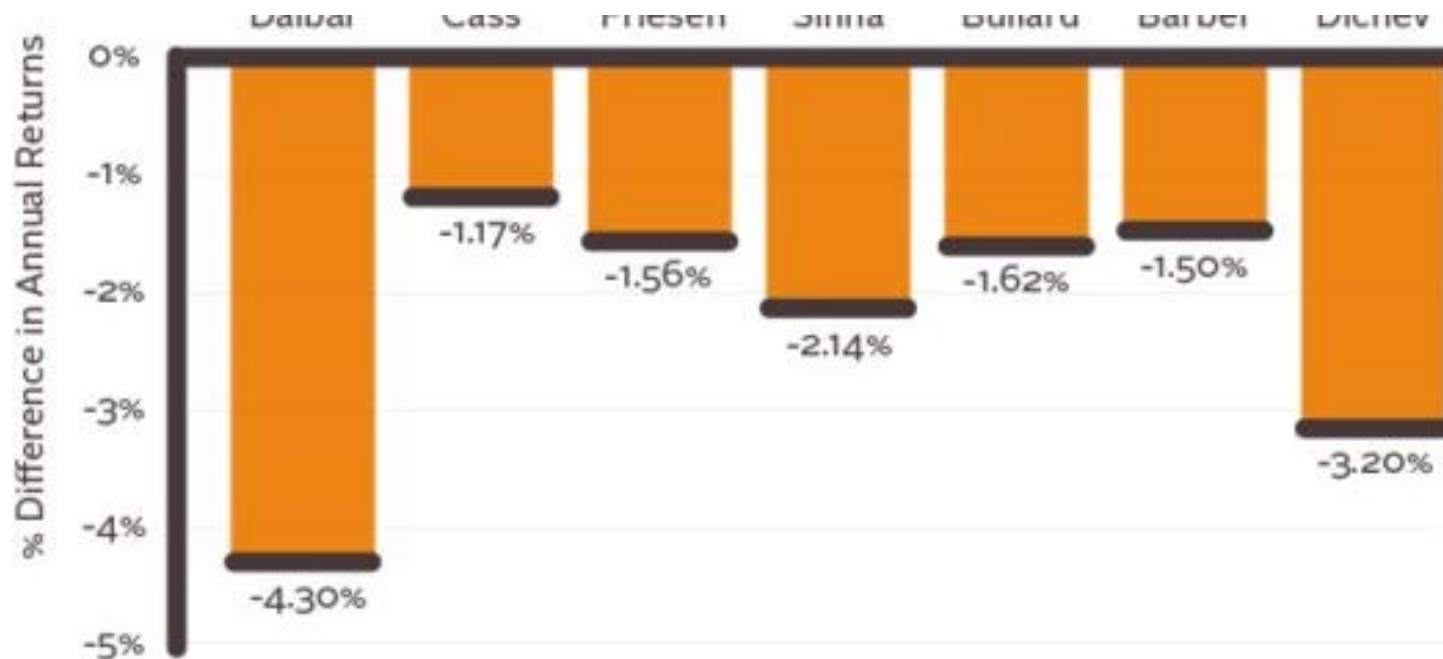
126
cases in
2014



A FIX WITH NO CURE

- 1. Willingness to speak up**
- 2. Kept from water source**

ESTIMATES OF THE BEHAVIOR GAP



ESTIMATES OF THE BEHAVIOR GAP

The behavior gap measures the loss that the average investor incurs as a result of emotional responses to market conditions. Several academics have studied and estimate the gap to be between 1.17% and 4.30% per annum.

OUCH! BAD BEHAVIOR IS COSTLY

2.25% average gap

\$2.3M – Good behavior

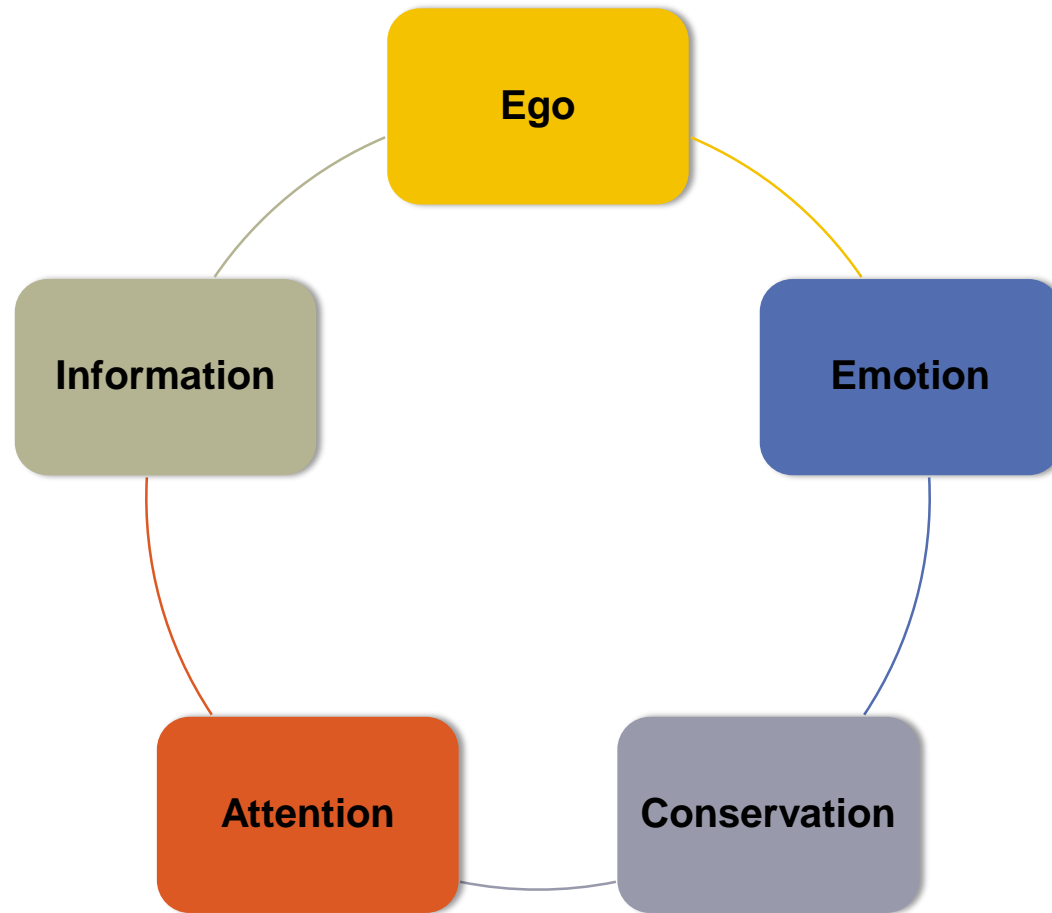
\$1.3M – Bad behavior

**Self-
Management**

**Wealth
Management**

2.25%

5 FACETS OF BEHAVIORAL RISK



177 WAYS TO SCREW UP

Ego – Worse than average sense of humor?

Emotion – Colors risk perception

Information – More is better

Attention – Salience over quality

Conservation – Safety and status quo

4 CS OF BEHAVIORAL RISK

1. CONSISTENCY

2. CONVICTION

3. CLARITY

4. COURAGE

CONSENSUS TENCY

PROCESSES BEAT PEOPLE

SNOOP AND DR. DRE LIED



MIND THE (BEHAVIOR) GAP

Classical music on the London Underground...

- **...robberies drops by 33%**
- **...assault drops by 25%**

WILLPOWER IS NOT ENOUGH

77%

OVER 50%



LOFTY MORALS OR LACK OF OPPORTUNITY?

- **25% of men cheat**
- **15% of women cheat**
- **“Sheer opportunity is the single best predictor of being unfaithful.”**

THE MAGIC IS GONE...

- **Automatic – 84%**
- **Benchmark – 63%**
- **Discretionary – 58%**

RULES > DISCRETION

- **Beats or equals expert – 94%**
- **Rules beat experts – 46%**
- **Experts beat rules – 6%**

Allows for lower fees!

35% RETURNS DON'T LIE

“...we slavishly follow the model. You do whatever it says no matter how smart or dumb you think it is. And that turned out to be a wonderful business.”

– Jim Simons, Renaissance Technologies

CONVICTION

FOCUSED ENOUGH TO BE WORTHWHILE,
DIVERSIFIED ENOUGH TO BE HUMBLE

PASSIVE IN ACTIVE CLOTHING

8% of ETFs are HC

23% of mutual funds are HC

Average expense ratio – 128 bps

HOW MUCH IS ENOUGH?

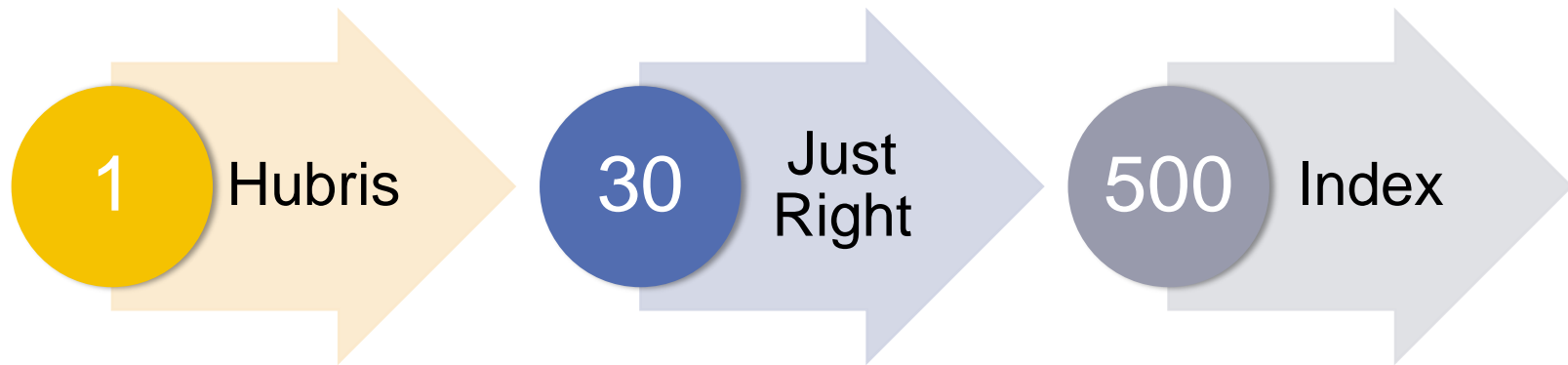
Four – 72%

Eight – 81%

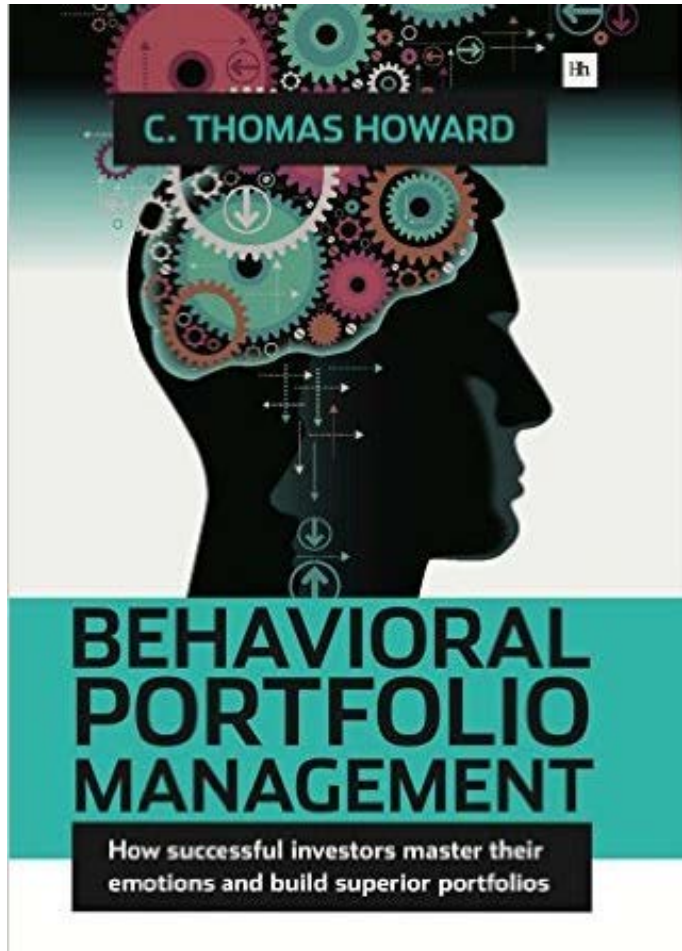
Sixteen – 93%

Thirty-Two – 96%

"GOLDBLOCKS" DIVERSIFICATION



ACTIVE MANAGEMENT WORKS



6%
outperformance
for top holdings
of active mutual
fund managers

Guts > Brains

A BEHAVIORAL GLITCH

- **2000 - ~50% tech stocks**
- **2008 - ~40% financials**

Cheap, small stocks outperform

Indexing overweights big, expensive stocks

PASSIVE IS A FICTION

- **1995 – 12% of additions are tech**
- **2000 – 41% of additions are tech**

Broke rules to add AOL

The question is not “if” but “how?”

CLARITY

COMPLEX DYNAMIC SYSTEMS REQUIRE
SIMPLE RULES TO AVOID OVERFITTING

COMPLEXITY KILLS: 1961 VS 1970

<p>Feature Index</p> <table border="0" style="font-size: small;"> <tr> <td>Editor</td> <td>11</td> <td>Editorials</td> <td>6</td> </tr> <tr> <td>Announcements</td> <td>4</td> <td>Sports</td> <td>87</td> </tr> <tr> <td>Classics</td> <td>25</td> <td>Society</td> <td>5</td> </tr> <tr> <td>Crossword</td> <td>28</td> <td>Ward Info</td> <td>26</td> </tr> <tr> <td>Justice</td> <td>11</td> <td>Radio-TV</td> <td>28</td> </tr> </table> <p>25 PAGES TODAY</p>	Editor	11	Editorials	6	Announcements	4	Sports	87	Classics	25	Society	5	Crossword	28	Ward Info	26	Justice	11	Radio-TV	28	<h1 style="font-size: 2em; margin: 0;">The Huntsville Times</h1>	<p>Where Progress...</p> <p>Covers The Valley!</p>
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VOL. 91, NO. 21	CHICAGO DAILY NEWS SERVICE HUNTSVILLE, ALABAMA, WEDNESDAY, APR. 12, 1961	ASSOCIATED PRESS — WIREPHOTO 45¢ PER WEEK																				
<h1 style="margin: 0;">Man Enters Space</h1>																						
<p>'So Close, Yet So Far,' Sighs Cape</p> <p>U. S. Had Hoped For Own Launch</p> <p>CAPE CANAVERAL, Fla. (AP) — The Redstone rocket which the United States had hoped would boost the first man into space stands on a launching pad here. The Soviet Union beat its firing date by at least two weeks.</p> <p>"So close, yet so far," commented a technician who is helping groom the Redstone to send one of America's astronauts on a short sub-orbital flight, hopefully late this month or early in May.</p> <p>"If we hadn't had those troubles last fall and on the thingy and Lavinia Joe starts this year, we might have made it," the technician said.</p> <p>"But you have to give the Russians scientific credit. They've accomplished a remarkable breakthrough."</p> <p>Dr. Hugh Dryden, deputy director of the National Aeronautics and Space Administration, said</p>		<p>Soviet Officer Orbits Globe In 5-Ton Ship</p> <p>Maximum Height Reached Reported As 188 Miles</p> <p>MOSCOW (AP)—A Soviet astronaut has orbited the globe for more than an hour and returned safely to receive the plaudits of scientists and political leaders alike. Soviet announcement of the feat brought praise from President Kennedy and U. S. space experts left behind in the contest to put the first man into successful space flight.</p> <p>By the Soviet account, Maj. Yuri Alekseyevich Gagarin, rode a five-ton spaceship once around the earth in an orbit taking an hour and 20 minutes. He was in the air a total of an hour and 48 minutes.</p> <p>The whole sequence of events and the announcements relating to it raised a number of questions. The Soviet announcement said the flight took place today between 9:07 and 10:04 a.m., but some persons in Moscow's Western colony were skeptical that the feat actually came off today.</p>																				
<p>Hobbs Admits 1944 Slaying</p> <p style="font-size: x-small;">By BOB WARD</p>	<p>VON BRAUN'S REACTION:</p> <p><i>To Keep Up, U. S. A. Must Run Like Hell!</i></p>																					

TALEB ON CLARITY

“Both governments and universities have done very, very little for innovation and discovery, precisely because, in addition to their blinding rationalism, they look for the complicated, the lurid, the newsworthy, the narrated, the scientific, and the grandiose, rarely for the wheel on the suitcase.” You’ve likely seen an invention or idea and thought, “Why didn’t I think of that?!” The reason you didn’t may have a great deal to do with trying too hard.”

THE IKEA EFFECT

Group A

Recent college grad

Stable job with upper middle class salary

Last three months has not paid \$5,000 bill

Group B

Do a little work to find out if \$5,000 or \$10,000 bill has gone unpaid

71% vs. 24% - More effort = Worse Outcome

INFO LEADS TO BASE RATE NEGLECT

Linda is 31 years old, single, outspoken and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and participated in antinuclear demonstrations.

Based on this description, which is more likely?

A. Linda is a bank teller.

B. Linda is a bank teller and is active in the feminist movement.

LESS > MORE

Parole Board

(detailed interview and review of records with team of experts) – **6% correlation**

3 Factor Model

(offense, number of prison rule violations, past convictions) – **22% correlation**



YEAH, BUT WHAT ABOUT US?

- **More information = more confidence**
- **More confidence = riskier bets**
- **More confidence leads to difficulty “inverting”**

LESS IS MORE

Price

- Is it cheap?

Profit

- Is there a moat?

Pitfalls

- Are they honest?

People

- Do they care for shareholders?

Push

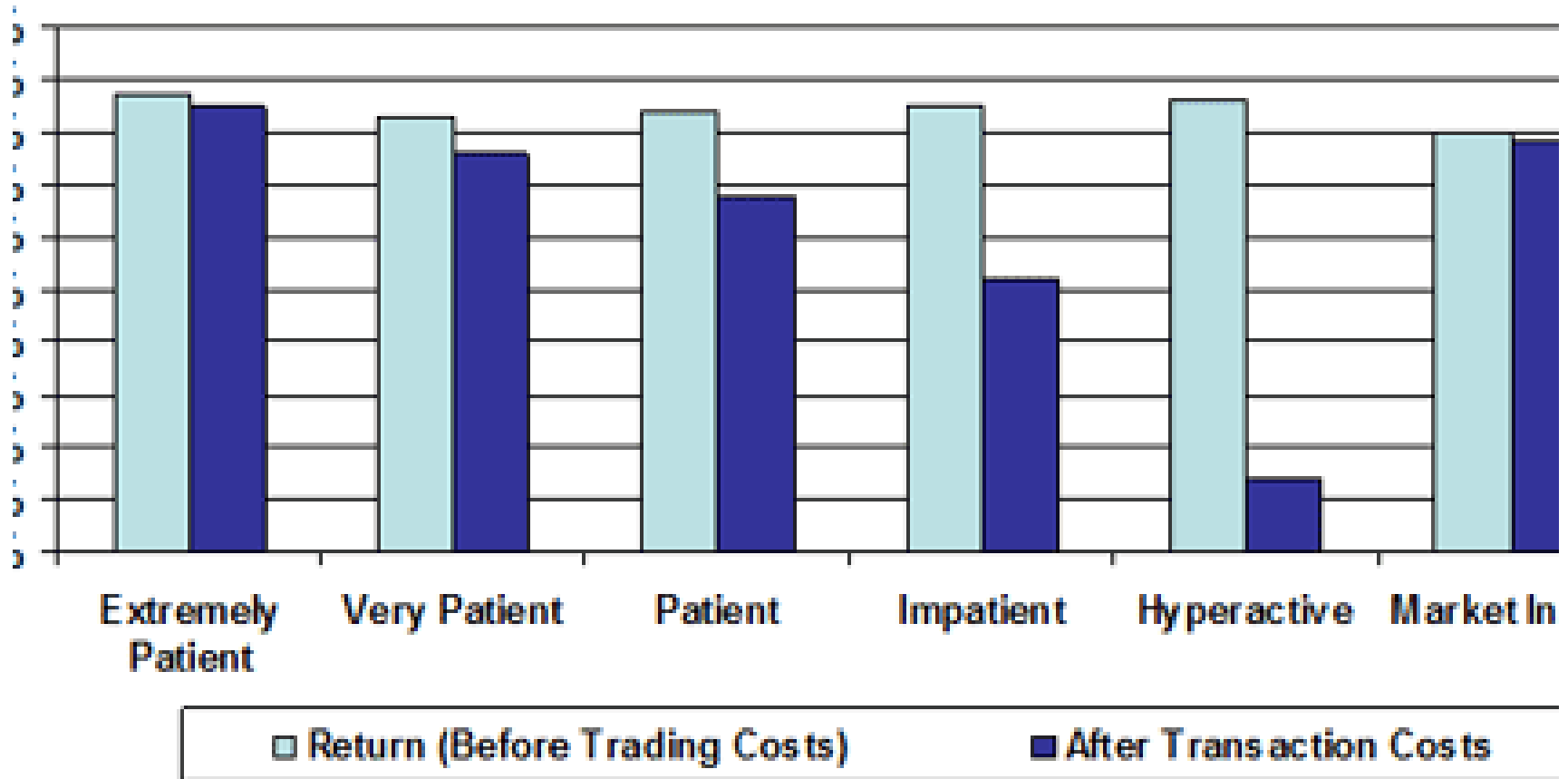
- Is there a catalyst?

COURAGE BUSINESS

DO WHAT IS BEST AND FEELS WORST



ACTIVITY IS HAZARDOUS TO YOUR WEALTH



FUGEDABOUTIT



WE'RE GETTING STUPIDER

South Sea – 720%

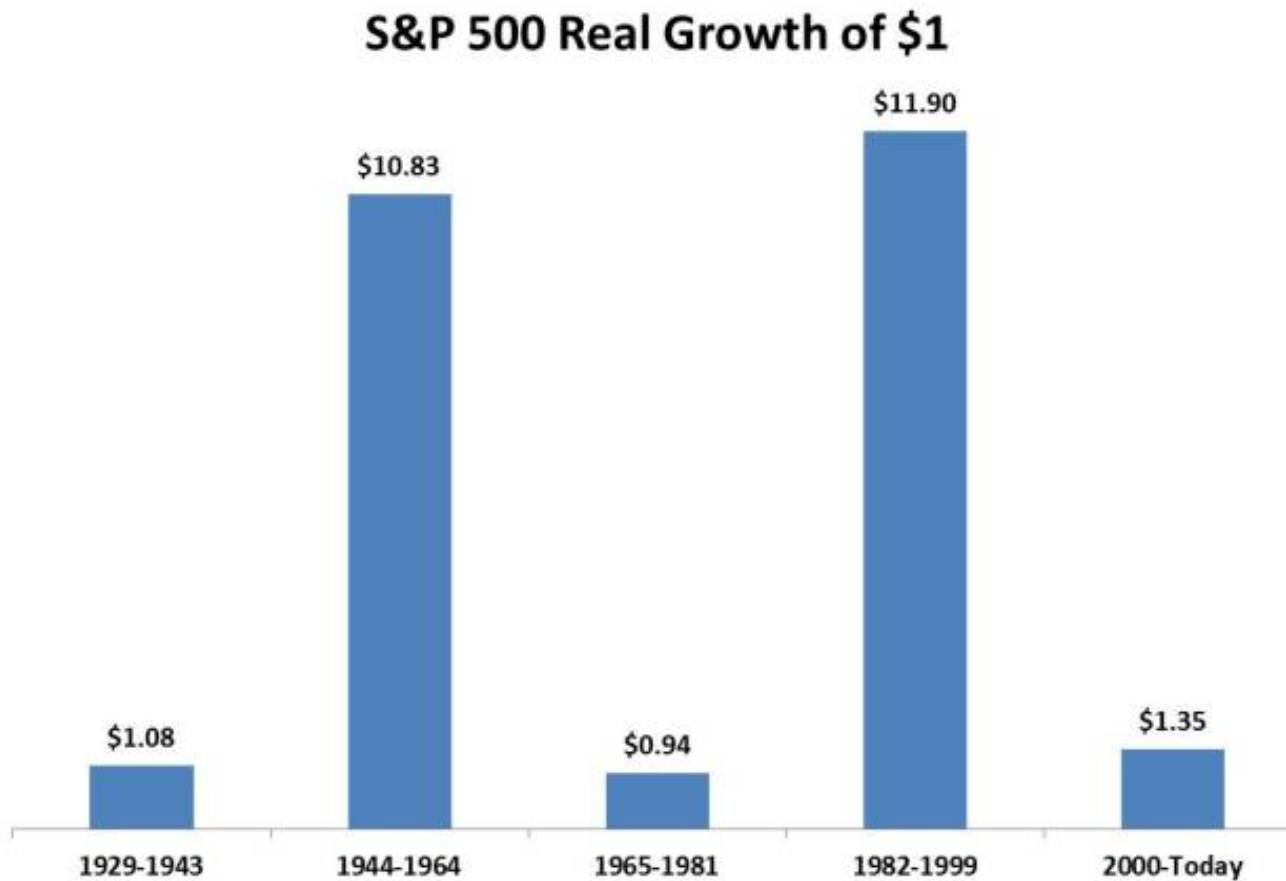
Tulips – 1500%

Amazon – 7500% (73% or recent high)

Yahoo! – 18,000% (25% of 1999 high)

Qualcomm – 22,000% (50% of 1999 high)

NOT EVEN THE MOST PATIENT...



\$%&! HAPPENS

**Every single G7
country has
experienced equity
market drawdowns of
75% or more**

THE BUBBLY TRIAD

Valuation, Momentum, Sentiment

- Below SMA 200 returns = 0%
- 7 false positives

- **September of 1998**
- **November of 2007**
- **August of 2015**

WHERE ARE WE?

- **Momentum** – Below 200 SMA
- **Falling since late last year**
- **Valuation** – 79th %ile

5 Year Projected Returns (Annualized) – 1.5%

Behavioral investing must give us the best of irrationality and protect us from the worst.

	Convicted	Courageous	Consistent	Clear
Ego	✓		✓	
Emotion	✓	✓	✓	
Information			✓	✓
Conservation		✓	✓	
Attention			✓	✓



YOU CAN BE
RIGHT AND
STILL BE A
MORON