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The Irrational Lizard Brain

Terry Burnham
Acadian Asset Management

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You wrote a book called Mean Markets and Lizard Brains (Wiley, 2008). What is the lizard brain?

The lizard brain is the part of you that wants to eat junk food, sleep in late, and watch TV. More formally, I define the lizard brain as all the brain except for the prefrontal cortex, the center of rational decision-making.

What is the most costly behavioral mistake investors make?

Investors tend to buy assets after they have gone up when they ought to buy assets that will go up.

How should they avoid making this mistake?

Lock up the lizard brain. In practice, this means setting up processes that don't allow emotional decisions. Slow and methodical is the correct way to make financial decisions.

If we are built to be bad investors, shouldn't we simply buy and hold cheap index funds and be done with it?

The key is emotionless, disciplined investing. For some investors, index funds can play a role, but there are other investing styles that can work well.

What techniques do you personally use to overcome your lizard brain?

When I get a brownie with my airline meal, I cover the brownie with mayonnaise. Thus, I am no longer tempted to eat it. In financial decisions, the lesson is the same. Put your money where you cannot make decisions in the short term.

What investor bias do you suffer from the most?

I get excited by big price moves. I want to buy assets that have gone up a lot and sell assets that have been dumped. The difference between successful and unsuccessful is not in our emotional response to price moves, but in our behavior. Almost everyone wanted to sell stocks in the spring of 2009, but not everyone made that mistake.

Acadian uses quantitative models to attempt to capitalize on investors' behavioral errors. How does this process work?

First, we are structurally set up to follow a disciplined process and not make most behavioral mistakes. Second, we study investors' mistakes and build portfolios that we think are on the other side of these mistakes.

But can you completely remove the human element from the equation? How do you guard against human mistakes and biases that might creep in?

People are built to lose money in asset markets. The best approach is to understand that our instincts are inversely related to opportunity. With this self-knowledge, we can build processes that minimize the mistakes and hopefully take advantage of mispricings caused by others' emotional mistakes.

Any surprises about how investors behaved during and after the financial meltdown, or have they pretty much acted as you would have predicted?

Investor reaction has not been surprising. Investors made themselves much poorer by buying risky assets before the financial crisis and selling them during the crisis. It's a well-used playbook, and one that produces poverty.

What one lesson should financial advisors take away from your talk at the Morningstar Investment Conference?

"We have met the enemy and he is us." This was the message of the comic strip Pogo, and it is true for investing. Management of firms can be corrupt, monetary authorities inept, and governments wasteful. While these are truths about the world, investors will profit if they focus their energy on shackling their own destructive impulses that spring from the lizard brain.