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Behavioral Finance Part Two

This is part two of a three part article. Advances in behavioral finance have shed light on some of the contradictions and biases they have exposed in the last 10 plus years. Investing is not all numbers. Emotion, psychological factors and sociological interactions all influence how successful individuals are when it comes to investing. We continue our discussion of behavioral finance with a discussion of markets and advances in cognitive theory.

From raging bulls to desperate bears, psychology affects market sentiment.

The ideas we have presented all share the view of pricing problems being created by "irrational" market participants. Statman suggests we should accept market efficiency in the beat the market sense but reject it in the rational price sense. We agree both that beating the market is not easy and that the market is not efficient in setting prices. This is seen as a peace offering from the behaviorists to the modern finance practitioners. In our opinion we feel that this deference to modern finance is not warranted.

Markets are not easily beaten. It is also accomplished regularly. Things that are not easy are accomplished with regularity in life. Witness the number of swimming world records set at this past summers Olympics. Economic markets are no different. Much of the data that has been used to refute this claim has come from the mutual fund industry. With the constraints fund managers operate under it is no surprise that most fail to beat the market. The studies used have also been of poor design usually covering no more than five years worth of data. Failing to beat the market over a five year time frame (or shorter) does not constitute an inability to beat the market long term. The phrase beat the market is vague to begin with. Usually yearly returns are used. We are aware of no studies using longer time frames, say rolling five year returns. Rolling five year returns have been back tested and have been shown capable of outperforming the market especially with several value characteristics. Warren Buffett has said that value (characteristics) and growth (characteristics) are inseparable and that value describes the price you will pay for growth. One of the primary reasons that markets can be beaten is that there frequently is a disconnect between price and the intrinsic value of a company's stock.

The number of anomalies that behavioral finance has exposed is staggering. Standard finance is so riddled with these anomalies that some suggest that it is in dire need of restructuring. We again disagree with several of the authors in the behavioral finance field that seek to affirm the modern finance model with alterations. The models of modern finance have been proven false. Single falsifications are sufficient to disprove a theory, multiple falsifications guarantee it.

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> ***"Change is despised and feared because it destroys experts."***

Chances are the stock market will never be explained by an equation or series of equations due to its dynamic nature. The current batch lends credible proof to this statement. An equation that explains a large extent of why something happens is not automatically useful. The information that remains unexplained may be so useful as to effectively render the portion that is explained effectively useless. We offer this scenario as support. Assume that you die this Saturday night 2 seconds before midnight. It can be proven that you were alive that vast majority of the past week (well over 167 hours). It could be proven that you were very productive at work during the week. Your quality of life the past week may have been reported as very high. The predictive value may have been that you would be very productive in the weeks to come. The problem rests with the pesky last two seconds at the very end of the past week. This information is so important that it renders any other information useless. If you were to substitute expected return or beta or another modern finance term and its predictive ability, the same relationship evolves because they rely on historical data and are value repressive. They may predict with some accuracy certain investments at certain points in time, at other times the predictive value is questionable at best. Without the ability to determine when it is useful and when it is not, the net effect is that modern finance theory can not be relied upon.

It is apparent that some finance researchers are unable to ignore sunk costs when it comes to discarding failed ideas. Whole careers have been built upon Efficient Market Theory (EMT) and Modern Portfolio Theory (MPT). They have had great difficulty accepting research that has discredited their life's work. More than one behavioral finance finding has been questioned as having been data mined or attributed to the result of a computer error. Each hole that is punctured in the existing finance theory is explained away as an anomaly. Efforts to discredit behavioral finance research can be summed up by this statement: Change is despised and feared because it destroys experts.

It is not surprising that the advances in behavioral finance have paralleled the advances in cognitive psychology. Comments nave been made that behavioral finance brought psychology to the field of finance, in truth it has always been there. Cognitive theory has made strides in describing people's behavior specifically relating to economics.

Each act of cognition begins with a stimulus. This act occurs in a two system model that is initiated with percepts that vary based on the stimulation. System 1 involves fast near automatic responses that are what we know as intuition and system 2 involves reasoning. The quick responses elicited through system 1 are characterized as effortless but difficult to control or modify. System two is a much slower more deliberate, flexible, potentially rules based approach brought into play for problems whose answer is not readily accessible. This two system process lays the framework for the field of behavioral finance.

Intuition is very useful in daily life especially as our culture seems to face an ever increasing number of decisions to be made. If each decision required careful analysis we would quickly become bogged down into a state of perpetual analysis. We would not have enough time to make all of the decisions we routinely face. Looking at a mountain in the distance that appears hazy and no bigger than the distance between our thumb and index finger still gives us enough information. We are able to ascertain that the mountain is far away and much bigger than it appears when measured between our fingers held out in front of us. System one (intuition) compares this information with a prototype that is readily accessible in our mind. We have a virtually instantaneous response to this stimulus, as Cialdini calls it the "click, whirr" response. Several factors determine how accessible this informa-

Behavioral Finance Part Two cont.

tion is to us. Information presented immediately beforehand can act in a priming fashion. High states of emotional and physical arousal can greatly affect accessibility to the current state. This may reduce accessibility to other thoughts. A classic example is an argument. After an argument has ended you often realize salient information that you left out because you were so focused on a particular line of thought that it made the other information inaccessible. The context that information appears in also affects accessibility.

The concept of uncertainty is poorly represented in intuition. If someone throws a ball at you, you move to get out of the way. No other thought comes to mind. Other activities happen in this same fashion. An example is a stranger who reaches out to shake your hand. Your hand automatically starts to rise whether you know this persons intent or not.

Intuition is also affected by the framing effect. Some attributes of a stimulus are perceived more easily than others. Reciting the alphabet forward is much easier than reciting it backwards even thought you know all of the letters. Invariance or the idea that preferences are affected by irrelevant features of options or outcomes led to the rationality principle being violated.

Perceptions also play an important role in system one. Perceptions are reference dependent. A stimulus is compared to the current and immediately prior stimuli when forming perceptions.

Study in this area by Kahneman and Tversky eventually led to the formation of Prospect Theory. How information is presented and how subjects perceive it affect the decision that is made. When the same information is presented differently often the decision will change. The main advance was to illustrate that utility is reference dependent. The economic definition of expected utility formed in the 1700's has gone unchallenged in economics up to this point. The idea of expected utility assumes that responses will be the same when the same information in presented in different formats. This is the basis for the rationality assumption in EMT. Prospect theory destroys this definition and with it the underpinnings of modern finance theory.

Prospect theory has changed economics and finance forever. Decision making by carriers of utility is not done in a vacuum. The initial state, or the wealth, or number of goods possessed by the decision maker influences his/her decision. Time is the other factor that influences utility, again not the steady state that the economic definition suggests.

From intuition we have transitioned to system 2 and the use of reason. Reason is often associated with judgments. People rely on a limited number of heuristic principles to reduce problems down into solvable parts.

Attribute substitution or the relative strength heuristic involves examining related information and experience and shifting familiar attributes to the problem at hand. Study participants where given short fact and character definitions of a person and then asked to rank possible field of employment. The outcome had employment options with a smaller statistical chance being chosen as ranked more likely based on the description. Often the answer that was given was not the one that would have been given had probabilities been shown. This describes the effect of a "tunnel" as Piattelli-Palmarini describes in his book *Inevitable Illusions*. Respondents answered the question using the information that came to mind and had trouble accessing more pertinent information because of the way the question was framed. In effect they answered a question that had not been asked.

The accessibility of corrective thoughts heuristic can be thought of as the inability of system 2 to catch and correct errors that occur in system 1. System 2 is not brought into play unless the mind has access to information that leads the thought process to believe that a problem is not as straightforward as it appears. This is that fleeting thought that you get just before you answer a question that you have formulated a near instantaneous response to. That is system 2 kicking in and adding doubt to your system 1 response. The fact that system 2 has been brought into use is still no guarantee that your answer is right only that you have a chance to avoid some of the biases that each of us carry.

Watch List

High tide raises all boats. Since the elections the stock market has been on a roll. Eleven of the thirteen companies we are pursuing have risen in value in the past month. USG has risen from $18 to $36 in the past three months. They are still in bankruptcy. Investors appear to be getting a little ahead of themselves. This is the kind of price run up we expected when they emerged from bankruptcy. Sanderson Farms is another company that we have been waiting to purchase at a nice price. They have risen from $33 to $42 over the past three months. We cannot justify buying at these levels with the threat of avian flu out there. St. Joe has risen 25% in the same time frame. We still prefer Consolidated Tomoka to St. Joe. The companies that have fallen in price over the past few months are the ones that we find more attractive. It is in this area that we have no good news to report.

Company	Current price	New price	Change from Prev Month	P/E	52 Week High	52 Week Low	Estimated '04 EPS	Dividend Yield
Altria Group, Inc./MO	$58.16	$61.04	4.95%	12.8	$58.96	$39.60	$4.77	4.85%
Allergan/AGN	$79.02	$81.66	3.34%	29.6	$92.61	$68.59	$2.74	0.44%
Bioanalytical Systems, Inc./BASI	$5.40	$4.78	-11.48%	n/a	$6.23	$3.40	n/a	n/a
Genentech, Inc./DNA	$48.72	$51.50	5.71%	62.0	$68.25	$38.15	$0.81	n/a
Gentex Corporation/GNTX	$32.36	$34.18	5.62%	24.1	$47.08	$32.00	$1.46	2.01%
The St. Joe Co./JOE	$56.34	$60.09	6.66%	54.3	$56.99	$31.10	$1.02	0.96%
Landauer, Inc./LDR	$46.48	$45.44	-2.24%	20.9	$50.30	$35.08	$2.03	3.81%
Paychex, Inc./PAYX	$33.46	$33.80	1.02%	35.5	$40.54	$28.83	$0.94	1.60%
QLT Inc./QLTI	$15.70	$15.12	-3.69%	17.4	$30.70	$13.18	$0.85	n/a
Sanderson Farms/SAFM	$36.63	$41.95	14.51%	9.7	$55.18	$19.70	$5.12	1.00%
Tejon Ranch Co./TRC	$39.11	$40.42	3.35%	n/a	$43.21	$30.70	$0.00	n/a
USG Corporation/USG	$31.17	$35.96	15.37%	5.0	$35.99	$12.30	$6.09	n/a
The Washington Post Co. /WPO	$950.75	$960.01	0.97%	26.8	$983.50	$654.00	$34.67	0.75%

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The BCIA Portfolio

Company	Porfolio Percentage	Current price	Buy Price (less than)	P/E	Dividend Yield
Amgen/AMGN	**4.70%**	**$63.59**	**$60.00**	**22.5**	**n/a**
Astronics Corporation/ATRO	**4.40%**	**$4.92**	**$5.15**	**83.0**	**n/a**
Berkshire Hathaway B/BRK.B	**15.30%**	**$2,937.00**	**$3,050.00**	**n/a**	**n/a**
Cash	**9.90%**	**$1.00**	**n/a**	**n/a**	**n/a**
Cell Genesys, Inc./CEGE	**5.30%**	**$8.00**	**$9.00**	**n/a**	**n/a**
Consolidated-Tomoka Land Co./CTO	**27.00%**	**$43.10**	**$36.00**	**18.7**	**0.65%**
Kensey Nash/KNSY	**2.40%**	**$32.85**	**$26.50**	**24.8**	**n/a**
ModPac/MPAC	**10.40%**	**$12.90**	**$10.20**	**17.2**	**n/a**
OMI Corporation/OMM	**19.10%**	**$16.71**	**$16.90**	**7.3**	**1.60%**
Protein Design Labs/PDLI	**1.50%**	**$20.09**	**$18.75**	**n/a**	**n/a**

The chart above shows our investments and the proportion of our portfolio they represent. As you can see we are heavily weighted towards four stocks. This is considered extremely risky by the popular investment community. We feel perfectly comfortable with it. Our trial issue on the website briefly delves into the issue of how you should build your portfolio. To achieve the same returns we will receive, you can buy all of the stocks we own in roughly the same proportion. You may be able to do better by purchasing the stocks we feel are worthy buys presently. These stocks are represented as the companies that are selling for less than our buy price.

How things change in a month. Last month we were singing the virtues of OMI and lamenting the fall of Cell Genesys. This past month the tables have been turned. OMI (-26%) has had a healthy drop and Cell Genesys (22%) has been one of our best performers. Overall we have had another strong month. Amgen is up over $8 (15%) and ModPac is up over $1.75 (16%). Could we have predicted it? No. Do we care much? Not really.

We still remain very satisfied with out portfolio. The companies we are interested in investing in have also done very well. We have not, nor do we plan on comparing the performance of the two groups.

We are eagerly awaiting next quarters earnings reports. We expect OMI, Consolidated Tomoka and ModPac to all have extremely strong quarters.

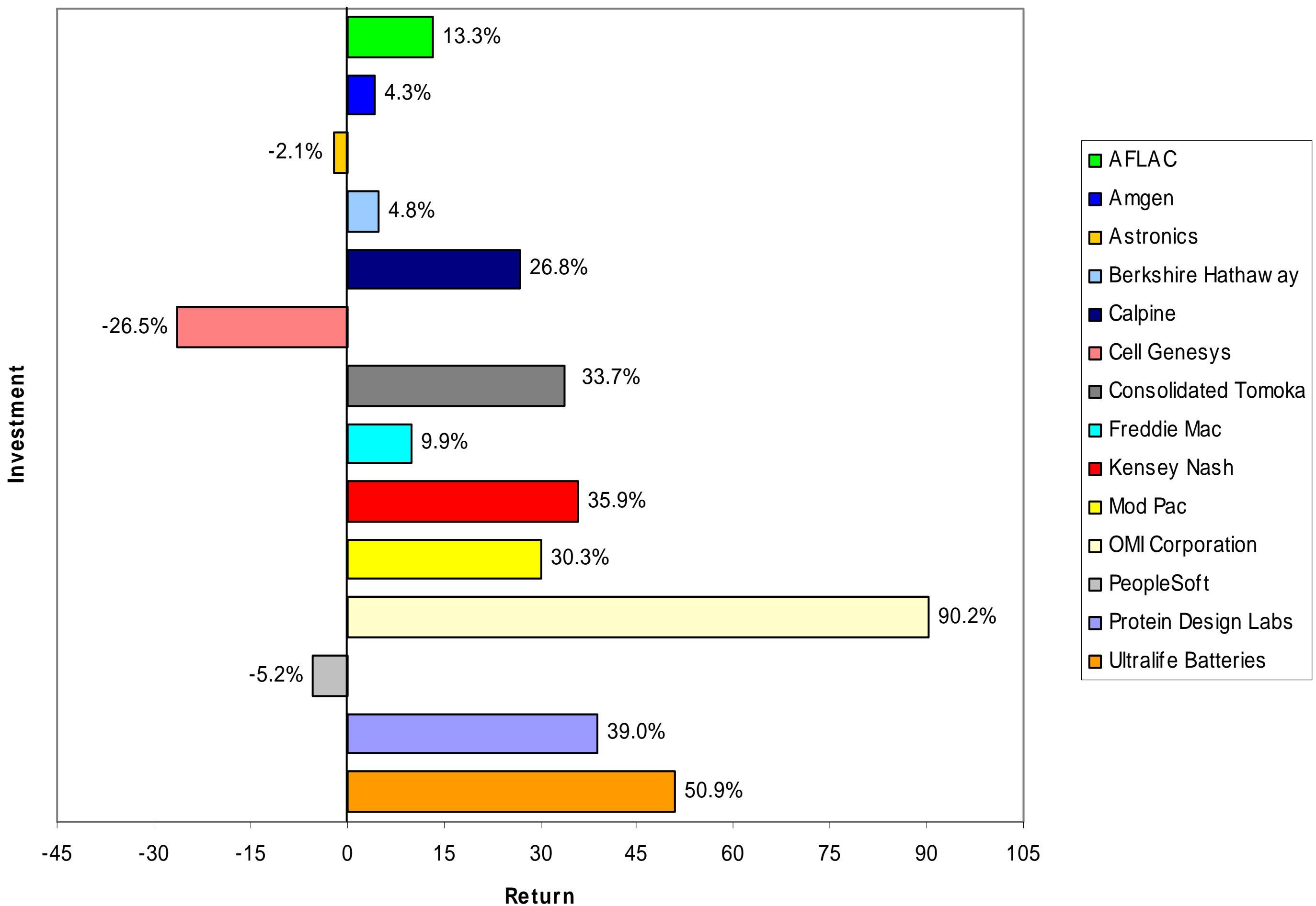
Just for speculation purposes, if ModPac has a fabulous quarter and the share price rises to the $15 per share area, we may sell. ModPac is not a company that we see holding for the long term. Short term the huge cash payment they received and its affect on earnings will boost share price to unjustifiably high levels. This is when we plan on making our exit.

Consolidated Tomoka has closed on one of their two large property sales this quarter. This will drive huge earnings. When the other large sale closes it will fuel another huge quarter. We estimate the current value of this company well over $60 per share. Hold tight and enjoy the ride. The shares have made nice gains through the fall and appear to reflect some of the good news already.

Protein Design Labs has had nothing but good news. The amount of money they generate from royalties continues to climb. Next year they should exceed $100 million in royalty revenue.

Returns

The graph below shows the stocks we own or have owned throughout the year and the returns we have achieved by holding them. If you were to look up the return for each of these companies the return you would see would vary from the returns we have achieved. Our returns only reflect the time frame that we owned the company and the amount that we had invested in each. The return on the stocks we held throughout the year are the easiest to make sense out of. Amgen we held the whole year so the return you would find for Amgen in any source would match our posted return. Ultralife Batteries which we held for a short time during the year may show a return far different than what any listed performance numbers would indicate. The most important part of this graph can be found in the performance of our four largest holdings. OMI, Consolidated Tomoka and ModPac all had returns over 30% for the year. Berkshire Hathaway was the sole laggard of our four core holding with a 4.8% return. Only two positions Cell Genesys and PeopleSoft showed losses. Both were extremely small parts of our portfolio.



Paying for College

If you have children, paying for college will rank with some of life's major expenditures. College costs are rising at near double digit rates while most folks incomes are not. If you do not begin to save when your children are young the amount that you will have to scrape together later on may break your budget. Four years at a state school can easily exceed $25k if your child lives at home. Four years at an elite private school can run more than $200k.

Compounding works as well paying for college as it does funding a retirement.

The time to start saving for your child education is now. We favor a plan that will allow you to accumulate a respectable amount of money with a minimum of pain. When your child is born we recommend opening a brokerage account in your name for your child. This strategy may not work the best for everyone and may not be the most tax efficient. It however works for us. Each child should have there own account and three income streams can fund it.

Each cash gift a child receives can be deposited into the child's account. When christening, communion, birthdays and holidays result in cash gifts they are promptly deposited. Parents provide the next income stream. We suggest contributing $50 per month to each account for the first three years and $25 each month after. If you have children who you have not started saving for you can adjust the amounts upward to play catch up. These monthly contributions may not sound like much but they add up nicely. The last source of funds will be funds that the child contributes themselves. This can be extra allowance money or money from part time jobs.

Contributing larger amount when the child is younger maximizes the compounding effect. What can you expect to accumulate following this program? It is our aim to see an account that is worth $25 -$40k. This will not pay for Princeton but will cover most of the tuition at a state school.

If your costs are expected to be much higher a great source of funds is Parent (Plus) loans through Sallie Mae a government sponsor of student loans. The loans require a 3% fee that can be rolled into the loan amount. For full details visit www.salliemae.com. The loans are available for 10 and 30 year terms. One interesting note, if the loans are paid back on time for 48 months, the interest rates is lowered by 2%. The loans are available based on need.

At age 18 you will have contributed $6,300 dollars to your child's education if you follow our plan. When combined with the other sources of funding an account worth $40k is a nice payoff. How well this money is invested will be the determining factor regarding how much the account is worth. The account can still grow through the first 3 years of school. Hopefully there will be enough remaining for a down payment on a house when school is over.

We favor keeping the account in the parents name for various reasons. The primary reason is because it will ensure that the money is used for college instead of a nice new car. If the account is in the child's name they can determine how the money is to be used when

Paying for College cont.

they reach 18. Another important reason deals with the financial aid formulas. When financial aid is figured a larger percentage of a child's assets are expected to be used to pay for college than the parents. An account in the parents name will minimize the impact the account has on calculating any financial aid.

We can help you answer questions you may have on how to invest for your children's education. As always you can contact us through the web site or email us at contact@ebcia.com.

Tax Efficient

Try Avoiding Uncle Sam lately?

Tax time has arrived. We always strive to minimize taxes. Our strategy which involves trying to identify stocks we can buy and forget about goes a long way towards minimizing the effect taxes have on our investments. When you sell a stock that has gone up in value this creates a gain which is a taxable event. If you never sell you have nothing to worry about.

By buying stock in great companies you can expect to perform better over time than the market average and pile up your gains without generating any tax obligation. When you eventually do sell you may be looking at a sizable tax bill. If you buy 1,000 shares of a stock for $10 per share that rises to $50 per share and then sell, you have sizable tax bill. The gain would be $40 per share or $40,000. How it is taxed depends on your tax bracket. If it is a long term gain, which presently signifies that the security has been held for longer than a year, you can expect to pay between 5% and 15% tax depending on your tax bracket. If you are in the 10% or 15% brackets you will be taxed at the 5% rate. Filers in higher tax brackets will pay the 15% tax rate.

Earlier this year (Sep 04) we wrote about turnover. When we successfully identify stocks we can hold for a long time we can minimize our portfolio turnover. Minimizing turnover keeps taxes to a minimum. Taken to the extreme, if we had a perfect portfolio of stocks that would continually outperform the stock market and we never had to sell them, our portfolio would be as tax efficient as any tax deferred account. We would much rather have our dollars working for us than going to Uncle Sam.

It is great avoiding taxes but we refuse to make decisions based on tax consequences. When a company no longer fits our objectives we are inclined to sell whether we have a gain or a loss. The tax consequences can be far less painful than a large loss in share price. Your particular situation may dictate that tax consequences may play a more significant role in your decision making.

Another error we refuse to make is to avoid selling our losers. We derive a perverse pleasure in gaining a tax benefit for being able to ditch our mistakes. May there continue to be few of them.

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