The Commonsense

INVESTLETTER

Volume 3 Number 1

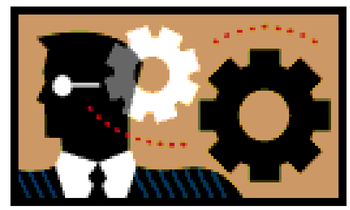
Behavioral Finance: part 3

Wall Street

- DJ 10393
- S&P 500 1168
- NASDAQ 2034

The third part of our article on behavioral finance covers how bias affects investment descision making.

Behavioral finance research has explored issues relating to how decision makers make economic decisions in real life. We will cover some of the more prominent biases and processes that affect decision. The disposition effect is one example of prospect theory being carried over to finance. Disposition in this case refers to how investors form their decision to ride losers and sell their winners.



How many of your dollars do you plan to keep and grow?

Investors are prone to anchoring which functions as a mechanism of regret avoidance. Regret is the tendency to feel bad about a previous decision. Investors show a reluctance to sell losers while being more likely to sell winners. They become anchored at the price the security was purchased at. They ignore the fact that stocks that have performed well recently tend to outperform for the next 3 to 16 months. The also pass up on the beneficial tax effects of selling losers. Some of the reason this may occur can be explained by the mistaken idea of mean reversion. They feel that their losers owe them the courtesy of at least getting back to break even. Along the same thought process they hurry and sell their winners before the price drops back down.

The concept of loss aversion and regret avoidance go hand in hand. Investors show a preference to avoid loss which would bring regret. Investors will trade less actively when their investments have lost money.   This helps confirm the research by Kahneman and Tversky involving prospect theory. Investors are not risk averse they are loss averse because of the negative feelings that are brought about.

Investors also exhibit overconfidence and over optimism. Overconfidence results in excessive trading. Investors are overconfident about their abilities, their knowledge and their future prospects. The companies that are sold tend to be companies that have gains in an investor's portfolio. Not only do the securities they continue to hold at a loss tend to underperform on average, they obviously can't even cover their commission costs. Overconfidence is never more prominent that in IPO's. IPO's outperform the market in the short term but woefully underperform in the long term. The hype that surrounds an IPO helps bring people a sense of confidence about the issue. If others confirm what they would like to happen, then they tend to believe the others are correct and therefore, so are they.

The overconfidence effect may be so strong as to render the relationship of the price of a security to the intrinsic value of a company deranged for an extended period of time. This effect has been

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shown to apply to smaller companies to a larger extent than larger companies. The effect is apparent in the fact that smaller companies trade at a higher book to market price than larger companies. Investors may be inclined to overweight the value of their own prior beliefs and underweight information like accounting data.

Women will love to hear that men appear to exhibit overconfidence more frequently then women. When information tends to be more straightforward, women estimate their ability to be equal to men. When information is more ambiguous, women estimate their ability lower than men. Often information that relates to stock performance is ambiguous. On average men end up trading more often and underperforming women investors. Overconfidence is expressed by the willingness to trade more frequently on ambiguous information.

The Fed Chairman Alan Greenspan has stated that overconfidence is one reason recessions are difficult to forecast. He went on to say that our economic models have never been successful capturing a process driven to a large extent by a non-rational behavior. From this he coined the term “Irrational Exuberance” to explain the stock market levels of the late 90’s.

Overconfidence is never more prominent than when highlighted by this finding that verges on comical: Kahneman highlights a systematic error of judgment in people when he points out that 80% of drivers rate themselves as above average. In other words drivers are biased about their ability. That sure does not go far when explaining our car insurance rates. With all of these “good” drivers on the road you would think we would be paying much lower insurance rates.

Another bias that has been explored is the status quo bias. Investors anchor on the price they pay for a security. If a security they buy drops in value they become reluctant to sell because this will cause regret. They become overly focused on the price they paid for a stock. We have all heard the comment that I will sell once the price gets back to where I bought it at. The status quo becomes that price they paid for the stock. The issue that should concern the investor is the future prospect of the stock. Instead the hope that the price returns to its original level becomes the focus. The status quo bias also was exhibited in another study where one set of subject were told they inherited funds to invest. They are given several choices that they can invest the money in. Another group is told they have inherited cash and equities (stock) of which a large portion is invested in a moderate risk company. The second group was told they had the same options as the first group as far as what investments they could place the money into. The second group chose the option that they already had (cash and moderate risk stock) far more often than the first group did. This highlighted the status quo effect. The preference for the cash and equity portfolio rose when subjects were told that was how the money was invested when they inherited it.

Many of these biases overlap to create a variety of results. The bias of self attribution describes the value investors place on information that confirms or rejects their actions. Investors have been shown to believe that good performance is related to their superior ability to interpret information and events. They will attribute poor performance to chance or events that were out of their control. This bias has an interesting relationship with over confidence. When information come in that confirms an investor’s belief, his/her confidence rises. Information that does damages his belief lowers his confidence to a lower extent than information that would cause it to

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rise. The result will be an overreaction on the positive information. This overreaction will tend to reverse at some point in time. This is one cause of market volatility which leads to an unhinging of price from value. Behavioral finance goes on to claim that the stock market exhibits excess volatility. Recent research has explored the nonlinearity of prices and of the application of fractal theory to pricing as a means to explain this finding.

The last area we will discuss regarding bias is mental accounting. Mental accounting is the tendency people have to compartmentalize their investments. Investors have been shown to have multiple views of risk. Each investor has multiple goals. Some of their assets may be earmarked for more conservative investments. For example funds set aside for a child's education. Other funds are set aside for more risky investments. Especially if they perceive they have enough assets set aside for their major life goals like retirement. Each pool of assets is accounted for separately in the mind of the investor. What is acceptable for one pool of money is not for another. Modern finance tries to apply one standard measure of risk and one optimum asset allocation to an entire portfolio. This highlights another failure of modern finance to encompass the real life actions of investors.

Only recently have the findings of behavioral finance begun to be applied to real life finance problems. As we stated earlier behavioral finance has no central theory. This has led to the diverse findings of behavioral finance being applied piecemeal to particular areas in finance. Areas receiving attention include asset allocation, gender and personality types and their influence on investing, and linking goals with investment management. We expect to see more papers of this nature based on what we believe will be the inability to distill a field as complex as investing down to one or a few all defining equations. The relationship of individuals, their psyche, investments and the real world application of complex individual decision based on complex information will prove to be a difficult beast to master. This does not mean that research of this type is of no value. Just the opposite is true. The caveat is that the findings will have to be narrowly defined while still being able to account for a diverse means of application.

In this area behavioral finance has excelled. By acknowledging that value expressive behavior does affect decision, behavioral finance allows for different interpretations by different people to still be "rational" behavior. Best of all current research is attempting to explain how real life people react, not modern finance's attempt to explain their self derived rational actor.

This approach has upset the apple cart. Several years ago it was discovered that the vast majority of ulcers (over 80%) were caused by a bacteria. Previously it had been thought that diet and stress had been the major factors leading to ulcers. It took several years before many doctors would acknowledge the change in reality. Undoubtedly you can still find holdouts who insist on treating ulcers as if the new findings are irrelevant. It becomes easy to become comfortable with what you already know. For many, change is difficult. Think status quo bias. The time for change is here. Over the next few years you will see a gradual shift in how finance is practiced.

Much of our paper has focused on refuting modern finance. In our view modern finance will continue to lose credibility and eventually a vacuum will be created that will allow behavioral finance and other areas of research to become the mainstream underpinnings of finance theory. Instead of finance becoming more unified we see a greater dispersion in ideas that will each explain a small part of finance. Behavioral finance has done a great job borrowing from psychology to explain behavior. Sociology has much to offer and has just briefly been touched. Group dynamics is an area that can be applied to the herd behavior that occurs in markets. Panics and crashes may have a strong group component.

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Watch List

Again we have added new companies to our watch list. New to this months list are CFC International, Fresh Del Monte Produce and Rayonier. CFC is another small printing company along the lines of our ModPac. They specialize in security printing and take advantage of their specialty knowledge of printing complex holograms. Their other main line of business involves printing laminate films that have the look of wood, marble, granite, etc. This is the fake wood grain that covers the surface of all of the ready to assemble furniture. We love business' like Fresh Del Monte (FDP) that are easy to understand. They derive most of their revenue from bananas and pineapple. FDP generate piles of cash without requiring tons of assets. Rayonier is a timber company that owns 2 million acres of land in the northwest and southeast. We are interested in the land. The timber business throws off a tidy profit and their corporate structure allows them to pay a 5% dividend. They have considerable holdings along I-95 in Georgia and Florida. Rayonier's land is north of the land that Consolidated Tomoka owns.

Last month we bemoaned the difficulty we have had in figuring a reasonable estimate of St. Joe's worth. With their price climbing so rapidly it is an issue we do not have to contend with presently. St. Joe is not the first time we have missed out on nice gains from hesitating on an investment and it definitely will not be the last. Shares have risen 50% over the past six months we have been investigating them.

USG has been seeing a reversal of their meteoric rise over the past 2 months. The price rose after the presidential elections when it was presumed that the asbestos bailout package was a done deal. This legislation has taken longer than expected and USG is pulling back from their recent highs. Even with the still huge price increase the company is a bargain. We still prefer to wait until the bankruptcy cloud is removed.

Company	Current price	Last Months price	Change from Prev Month	P/E	52 Week High	52 Week Low	Estimated '04 EPS	Dividend Yield
Altria Group, Inc./MO	$62.29	$61.04	2.05%	13.2	$64.00	$39.60	$4.77	4.70%
Allergan/AGN	$77.76	$81.66	-4.78%	28.2	$92.61	$68.59	$2.74	0.47%
Bioanalytical Systems, Inc./BASI	$5.13	$4.78	7.32%	n/a	$6.23	$3.40	n/a	n/a
CFC International/CFCI	$14.95	$14.46	3.39%	29.8	$5.29	$17.88	$0.50	n/a
Fresh Del Monte Produce/FDP	$29.12	$28.81	1.08%	n/a	$22.62	$29.80	$2.04	2.70%
Genentech, Inc./DNA	$47.46	$51.50	-7.84%	14.4	$68.25	$38.15	$0.81	2.73%
Gentex Corporation/GNTX	$33.13	$34.18	-3.07%	23.1	$47.08	$32.00	$1.46	2.08%
The St. Joe Co./JOE	$68.24	$60.09	13.56%	60.8	$56.99	$31.10	$1.02	0.83%
Landauer, Inc./LDR	$45.46	$45.44	0.04%	20.8	$50.30	$35.08	$2.03	3.81%
Paychex, Inc./PAYX	$30.51	$33.80	-9.73%	32.7	$40.54	$28.83	$0.94	1.69%
QLT Inc./QLTI	$17.00	$15.12	12.43%	19.1	$30.70	$13.18	$0.85	n/a
Rayonier/RYN	$45.80	$48.59	-5.74%	21.2	$37.51	$49.68	$2.13	4.95%
Sanderson Farms/SAFM	$43.80	$41.95	4.42%	9.8	$55.18	$19.70	$5.12	0.96%
Tejon Ranch Co./TRC	$43.50	$40.42	7.62%	n/a	$43.21	$30.70	n/a	n/a
USG Corporation/USG	$33.71	$35.96	-6.26%	4.5	$41.67	$12.30	$6.09	n/a
The Washington Post Co. /WPO	$911.00	$960.01	-5.11%	25.8	$983.50	$654.00	$34.67	0.82%

The Investletter Portfolio

The chart below 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.

This month we have changed the provider we use for our P/E info. The method of calculation has changed so some of the values may be slightly different. This is about the only thing that has changed in the last month. If we were paid based on our activity you all would have been cheated the past 6 months. Get your computer mouse (or telephone) ready we may make a couple of short term trades. At these levels we see Cell Genesys (CEGE) being at the low end of their valuation. We will probably recommend a trade at levels less than $6.90. The continue to burn through cash at a rapid clip but they are moving closer to having a candidate ready to submit for FDA approval. CFC International (CFCI) a company we have added to our watch list has been exhibiting a rather narrow trading band. We may be able to make a quick profit similar to what we did with Ultralife Battery (ULBI) last year. Watch your email for updates.

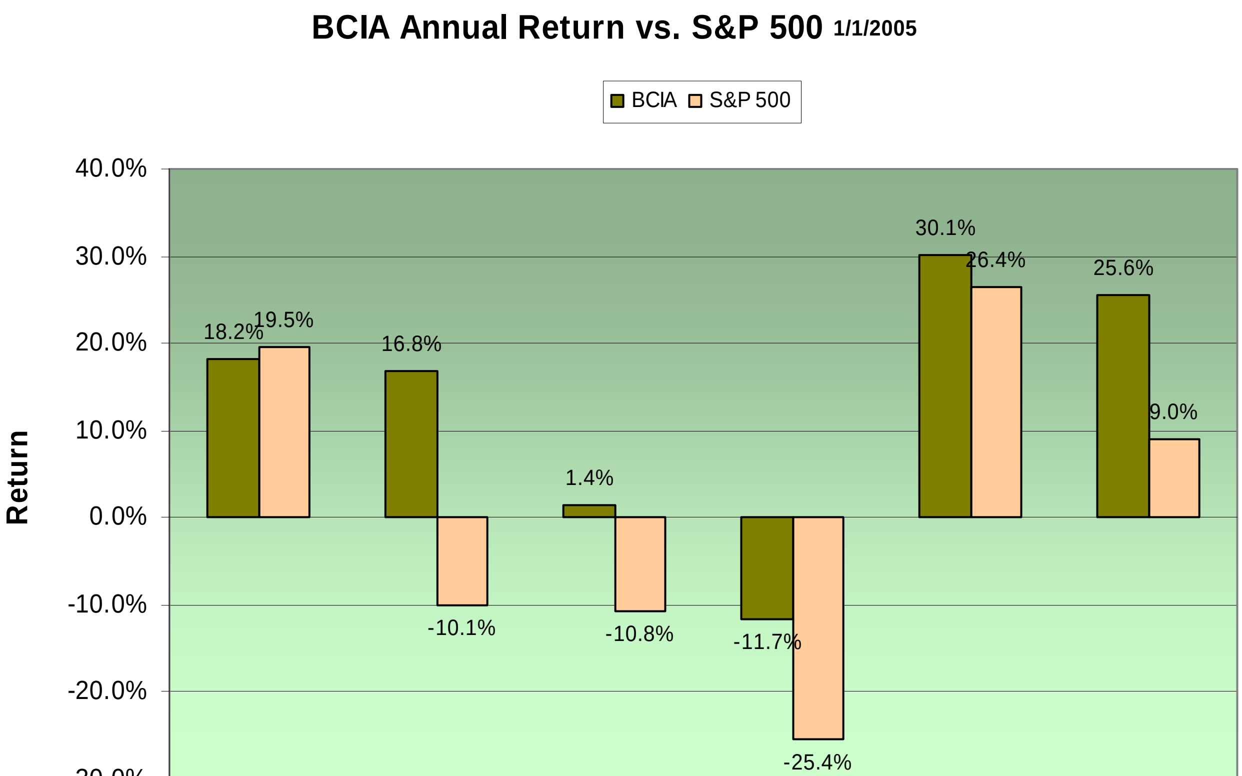
Protein Design Labs (PDLI) has announced an acquisition of another biotech company. They acquired privately held ESP Pharma for $475 million. ESP has two approved products that generate revenue of $90 million. This will help PDLI become cash flow positive next year. This is a huge event for a young biotech company. PDLI aims to have a product approved for marketing in 2008 (FDA permitting.) Sometime after this the company had hoped to start generating positive cash flow. (Cash flow is slightly different from earnings. A company can be cash flow positive but still be losing money. It is a move in the right direction.) PDLI now has revenue from products to go with their significant royalty stream. We a delighted with this news and see this as a catalyst for the next move upward.

If you get the chance, check out Berkshire Hathaway's earnings report when it comes out. The should show a big boost from Warren Buffett's bet on foreign currency. The stock could move up nicely.

Company	Porfolio Percentage	Current price	Buy Price (less than)	P/E	Dividend Yield
Amgen/AMGN	**4.70%**	**$63.56**	**$60.00**	**21.9**	**n/a**
Astronics Corporation/ATRO	**4.20%**	**$4.88**	**$5.15**	**78.7**	**n/a**
Berkshire Hathaway B/BRK.B	**15.50%**	**$2,964.00**	**$3,050.00**	**21.6**	**n/a**
Cash	**9.90%**	**$1.00**	**n/a**	**n/a**	**n/a**
Cell Genesys, Inc./CEGE	**3.70%**	**$6.77**	**$9.00**	**n/a**	**n/a**
Consolidated-Tomoka Land Co./CTO	**27.40%**	**$43.26**	**$36.00**	**18.9**	**0.65%**
Kensey Nash/KNSY	**2.20%**	**$30.13**	**$26.50**	**24.9**	**n/a**
ModPac/MPAC	**10.40%**	**$12.72**	**$10.20**	**17.3**	**n/a**
OMI Corporation/OMM	**16.40%**	**$16.30**	**$16.90**	**5.8**	**1.60%**
Protein Design Labs/PDLI	**1.50%**	**$20.26**	**$18.75**	**n/a**	**n/a**

Year End 2004 Return

We have come to the close of a very rewarding year. Our stock picks were up 25.6% in 2004.The S&P 500 which serves as a barometer for the overall market was up 9%. The last year we underperformed the market was in 1999. May 2005 see the streak continue.



	1999	2000	2001	2002	2003	2004
BCIA	18.2%	16.8%	1.4%	-11.7%	30.1%	25.6%
S&P 500	19.5%	-10.1%	-10.8%	-25.4%	26.4%	9.0%

Year

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Investletter

Principles Don't Change.

Our abilities are unaffected by how we dress. Don't be fooled by those whose only ability is dressing well.

This issue is our first of the new year and is the first with our new newsletter name. We have changed the name of our newsletter to The BCIA Commonsense Investletter. The highlight is on the Investletter part. Providing good stock picking advice has worked very well for us over the past 10 years. Marketing has not come quite as easy. We have come to the conclusion that we could not be taken seriously with the words Blue Collar in our newsletter name. Blue Collar represents a simplicity that we closely identify with. We have a hard time trusting the Suits (folks who wear suits while plying their trade.) Corporate scandals led by shady business executives, insurance salesmen pushing needless products (annuities come to mind) to generate commission for themselves, car salespeople all dress in suits. We could spend a whole article talking about how we view those wearing suits as pretentious. We include ourselves in this group when we are forced to "dress for success." (We would not think of wearing a suit when we write the newsletter or perform the research on the companies we are interested in.)

The same factors affected our decision to change our name. Blue Collar is not a term many people associate with investing. No matter how good our results are we were prejudged based on our name. We associate strongly with the hard work ethic and simplicity that the words Blue Collar inspire but realize that the name of our newsletter is better off changed. Our values remain the same. Our company is still Blue Collar Investment Advisors just that the name of our newsletter is now different. If you are expecting complexity and fancy cloths and an air of superiority from those who provide your financial advice we will consistently disappoint.

Our distance from the Wall Street mainstream (in miles and in thought process) works to our advantage. Independent thought is rewarded in investing. Following the crowd leads to the same results the crowd receives. This serves as our segue into our performance the past year. This newsletter has been an immense undertaking. Even larger than we initially anticipated. Our hope is that you have enjoyed our first years worth of issues.

We have talked before about our concern of being able to help our subscribers outperform the market. If we can't do this on a regular basis then you need to find another provider of advice (preferably others who also shun wearing suits) or just invest in the market through an S&P 500 mutual fund or an equivalent device. Our goal when beginning the newsletter was to provide you value by helping you earn more than what you would if you invested in something like the S&P 500. We initially viewed our subscribers as having at least $10,000 to invest or a plan to get to this level in several years. If we could outperform the market by 1% this would be an additional $100 that our subscribers would earn over what they could have made by investing in something like an S&P 500 fund. After the price of a$95 subscription the investor would still have been up $5. Not a lot of money but enough so we would not be guilt ridden for having cost our subscriber money by following our advice.

Investletter cont.

Based on our last years results we can relax for at least a few weeks with a confidence that a subscription was money well spent. The S&P 500 earned a 9% return last year. If you started with us in the beginning of the year and mirrored our suggested portfolio you would have had a 25.6% return. On a $10,000 portfolio you would have made and extra $1,565 ($1660– our $95 subscription) over the $900 you would have made investing in a S&P 500 mutual fund. On a $50,000 portfolio it would have been an extra $8,205. It also marked our fifth straight year of outperforming the market. (We are intentionally avoiding any mention of the year that occurred six years ago because it suits us well to ignore it. Otherwise we would be talking about our seventh consecutive year of outperformance. Maybe we can talk about this in early 2007.)

Over time we aim to outperform the market. In any given year we could easily underperform.

We are extremely satisfied with our 2004 results and looking forward to 2005. As usual we can make no guarantee of our results and caution you not to judge us on one years results. In any year we may not perform as well as the market. If we do manage to outperform the S&P average this year, we expect it will not be by as wide a margin as it was in 2004. Thank you for your confidence in us and thank you for subscribing.

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Behavioral finance has thrust a mortal blow to modern finance. Other areas of research are beginning to confirm what behavioral finance had already uncovered. Modern finance is so riddled with anomalies that it has become effectively useless. Future research can help explain how investors make their decisions and alert us to how we can avoid making poor decisions. From a practical standpoint behavioral finance will lead to investment strategies for individuals that more closely align with helping them achieve their goals.

We felt that this three part article we authored would explain how we view investing through a behavioral finance lens. We have mentioned before that we disagree with a great deal of modern finance theory. Diversification is a great example we would rather invest in 5 stocks we understand extremely well and whose prospects we are relatively certain then add 15 more that we do not understand just for the sake of being more diversified. The only result we see is our returns being watered down.

By helping you understand how we view the investment process and the values that we apply in making our decisions we hope to make you more comfortable with the choices we ultimately make. We feel a great deal of responsibility in making sure the stock picks we make will benefit our subscribers.

BD

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