The Quarterly Report

A QUARTERLY PUBLICATION OF IRON CAPITAL ADVISORS | Fall Issue | October 2021

Feel vs. Real

INSIDE STORY

IRON CAPITAL ADVISORS

3355 Lenox Rd., Suite 925
Atlanta, GA 30326
T 800.417.3804 | F 678.805.0534
www.ironcapitaladvisors.com

Feel vs. Real

There I was, in my living room, golf club in hand, watching a relatively new program called "Golf Academy" on the Golf Channel. A young Tiger Woods was the guest along with his then-instructor Butch Harmon. They were discussing Tiger's swing changes and how they went through them. They had used video analysis of Tiger's swing and Tiger said something I'll never forget. Discussing watching his own swing on video, he said, "There is a huge difference between feel and real."

What Tiger felt like he was doing in his swing and what he was actually doing were two very different things. Keep in mind, this was not some unathletic weekend hacker; this was Tiger Woods. He was already the greatest golfer of his generation and on his way to being, in my opinion, the second greatest golfer of all time. In all likelihood he has more body awareness than most other professional golfers, let alone us mere mortals. Yet there he was, entering the best stretch of golf in his incredible career, admitting that even he doesn't feel what is really happening.

What a great lesson: feel isn't real. I'm not even going to address the enormous difference between feel and real in my golf game, but this lesson from golf carries over to investing. We monitor our investment results continuously. We have both the market and our key strategies in front of us all day long when we are in the office. Every morning we review the actual results, and I can't tell you how many times I have asked that the results be double checked because they are not what I remembered, or should I say felt, from the previous day.

There have been times, although rare, when it turned out we did have some sort of accounting glitch in our system. There is often a delay in our system for dividend payments, and that can impact the daily numbers. However, the vast majority of the time it turns out that I was just wrong, and I have been doing this for 30 years. How could that be?

The fact is that when it comes to investing there are lots of psychological traps into which investors fall. One such trap is called anchoring. The textbook example of this is when an investor looks at a company that is currently selling for $20 per share. The stock of the company then drops to $10 per share, and the investor feels that the stock is now a bargain because the stock price was cut in half. The reality may be very different; perhaps the company was never really worth $20, even if someone was once willing to pay that amount. Perhaps it should be selling for $5. Locking onto the price at one moment in time can lead to all kinds of mistakes.

I tend to fall into that trap because on most days the relative results of our actual investments compared to the market do not change. In other words, when the market opens at 9:30 a.m. Eastern Time and all stocks trade for the first time that day, I look closely at our investments. Let's just say that on this particular day the market opens up 0.20 percent, and our investments open up 0.50 percent. In this example we are outperforming the market by 0.30 percent. That relationship usually holds for the rest of the day, no matter what the market does from there. So, if the market ends up 1 percent, I would expect our investments to be up 1.3 percent, and if the market ends up down 0.10 percent, I would expect us to be up 0.20 percent. The 0.30 difference remains the same. Unfortunately, this is also true on days we underperform.

I am conditioned to this because for the vast majority of my career this relationship has held true, but it isn't universal. Some days the relative action will change. Our differential will grow or shrink as the day goes on, and those tend to be the days when my feelings on the portfolio do not match the reality of the portfolio.

An even larger trap is the trap of confirmation bias. I once got into an argument with someone about the wisdom of reducing the national debt. This was right after the financial crisis of 2008 and the economy was weak. While I believe we should be concerned about the size of our national dept, I also felt that it was not a good time to prioritize it. Too many people needed help. He sent me a paper written by two Harvard economists and highlighted a sentence which warned of the dangers of too much debt. The message was something along the lines of, "take that." He had evidently failed to read the very next sentence in which the economists went on to say that now was not the time. He was not reading economic research papers in order to gain deeper understanding; he was simply looking for confirmation of his feelings.

One needs to go no further than social media to see confirmation bias in full force, as our more political friends (regardless of uniform) will cherry-pick data all day long "proving" their feelings to be correct and those other people to be not only wrong but evil. Feel is not real, and this is not a political newsletter. As investors we can fall in love with a company and when we do, we are in danger of seeing only positive data. We can also feel the market should go in a certain direction based on economics or politics or who wins the Super Bowl (don't believe that one? Google it). Then we look only for confirming signs, even when other data may point a different direction.

This can lead to another trap known as information bias. This occurs when our feelings are driven by information that may very well be correct and complete but has no actual bearing on investment decisions. Nothing is cheaper or more prevalent today than information, but most information is useless. Understanding the difference between real news and useless noise is actually one of the most important distinctions between professional investors and lay people. My personal favorite in this category is when the financial media has "Breaking News" along the lines of, "The market today is at its lowest point since last Thursday!" Oh my, panic and run, but take your smart phone so you can keep watching.

Think I'm teasing? Watch CNBC for a week and I guarantee there will be at least two such messages. This leads to two simultaneous traps. First, this is completely useless information. The media fixates on the price level of the market because it is the easiest and fastest-changing piece of data to discuss. However, it is useless when it comes to making prudent investment decisions because we don't invest in the market; we invest in specific companies, and while their price is certainly a factor, even then it is not usually the most important factor.

Secondly, we are once again anchoring. What was so impactful about last Thursday? Why is that the benchmark for the level of the market? Of course, the media don't care if you fall into a psychological trap and lose money; they only care about you watching the channel or clicking on that news alert.

Perhaps the most dangerous trap is the trap of loss aversion. Investors hate taking a loss. I was once sitting in a bar in O'Hare Airport getting a quick dinner before boarding my next flight and the gentleman next to me asked what I did for a living. When I told him, as is often the case he decided to impress me with his investing acumen. He said what he did was invest in stocks and if they went down, he would simply hold on until they got back to the price he paid and then he would sell. On the other hand, if they went up, he would sell immediately locking in his gain.

That is textbook loss aversion. Loss aversion is not the same as risk aversion. The latter is a rational idea that one should avoid unnecessary risk whenever possible. Loss aversion has more to do with the psychological need to be correct. The idea here is that realizing a loss on an investment is admitting a mistake and that does not feel good. The flip side leads to realizing profits quickly so that one can prove he was correct.

» *Continues on next page...*

REVIEW *of* ECONOMY

The 2nd quarter 2021 GDP growth came in up 6.7 percent as the economic recovery continues. As good as that is, it missed expectations by nearly 2 full points. Expectations for 3rd quarter started equally high but have been dropping rapidly. Growth is slowing.

The official unemployment rate is 5.2 percent in August. Jobs have come back at a rapid pace but workers have come back much slower than expected. Most of the additional unemployment benefits ran out in September, so we will see if that has an impact.

Inflation is 5.3 percent based on the latest consumer price index report. It has moved upward rapidly. The producer price index, which tracks wholesale prices, is up 8.3 percent over the last 12 months. Inflation is worrying everyone and even the Fed is beginning to notice. But will they act? +

REVIEW *of* MARKET

The markets were mixed this quarter. For the quarter, the S&P 500 finished up 0.58 percent, but small company stocks represented by the Russell 2000 index were down 4.36 percent. Growth and value were mixed as well, with growth doing better among large companies, but value outperforming in small companies.

Bonds were flat during the quarter. The Barclays U.S. Aggregate Bond index ended up 0.05 percent. High yield bonds rose 0.94 percent.

International stocks fell. The EAFE index finished down 0.35 percent while the MSCI Emerging Markets index ended the quarter down 7.97 percent. +

MARKET *forecast*

The market seems to be in the process of a correction. Most stocks have corrected while rotation has kept the S&P 500 from actually dropping. This correction should be a buying opportunity.

Value stocks and small company stocks still have more room to run in the long term, but economic growth concerns are growing. International stocks look more attractive than domestic.

Bonds remain at very low yields. They are still a shelter in a storm but are not going to fund any retirements. +

» *Continued –*

While this may make an investor feel smart (the gentleman at the bar certainly felt he was brilliant), it is in reality quite dumb. By quickly selling winners and holding onto the losers this investor ends up with a portfolio full of losers. Professionals attempt to do the very opposite: cut losses rapidly and let one's winners run. It may not feel as good, but the reality will be much better.

This year we have been exploring a theme in our Perspectives blog: If one cares about people, then one has to care about the result of policy and not just the intention of policy. In other words, one must care about real more than she cares about feel. Economically many policies feel good that in reality deliver increased suffering. There are also times when a policy that feels cold may lead to the best outcome.

So how do investors and policymakers guard against psychological traps that make us feel good while doing bad? In her book, "Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts," professional poker player Annie Duke describes many psychological traps into which poker players fall. She admits that she falls into them herself and comes to an interesting conclusion: psychological traps cannot be avoided. We are human beings, and our brains work like everyone else's. I have already admitted to anchoring, guilty as charged. Do you think we like telling our clients we are realizing a loss because we were wrong? Nope, we have egos just like that guy in the bar.

Confirmation bias is just human. We all do it. These traps cannot be avoided. However, as Ms. Duke points out in her book, what we can do is be aware of them. Knowing that we are human and subject to all the human psychological traps can help us remain humble and self-aware. We can't avoid the traps, but we can recognize when we are in one and think our way out of it.

We can constantly force ourselves to face reality. As professionals we are always measuring our portfolios. We run different types of analyses that force us to be honest with ourselves. Measuring the real results puts our feelings in perspective. We also rely on process; we have an investment philosophy that governs the big picture. We create specific strategies that are consistent with that philosophy and allow us to address client needs. We then create a process by which we implement these strategies. Process is key because it takes feeling out of the equation. We know the process works because it has been tested and we trust it.

We analyze results and determine if tweaks need to be made to the process, but we do not go on feelings. Tiger Woods was also unable to will his feelings into matching reality; he simply had to accept that the correct motion did not come from what he thought was the correct feeling. Not even he could change what he felt, but he could become aware that feel and real were not the same thing. That understanding, combined with immense talent and an unrelenting work ethic, made him the second greatest golfer of all time.

Likewise, we cannot re-wire ourselves to avoid our feelings, but we can become self-aware. We can recognize a trap when we fall into it and develop a process to get ourselves back out. That is the key to having a successful investing reality.

Warm Regards,

CHUCK OSBORNE, CFA *Managing Director*