Viewpoint: James Montier

Only White Swans on the Road to Revulsion

Biographies: James Montier

Introduction

James Montier, an expert in behavioral finance, argues that investors would have a greater chance of spotting the formation of bubbles if they could only brush up on their history and have a greater awareness of human psychology. Co-head of global strategy at Société Générale, Montier has been described as an "enfant terrible" by Frankfurter *Allgemeine Zeitung*, an "iconoclast" by the Financial *Times*, a "maverick" by the *Sunday Times* and "a prophet" by Fast Company. Montier, who formerly worked as an equity strategist at Dresdner Kleinwort Wasserstein, NatWest Markets, and Bankers Trust, has been a top-rated strategist in the annual Extel survey for the last five years. He began mining behavioral economics, then an emerging discipline, to explain investors' irrational behavior during the dotcom bubble. He is a visiting fellow of Durham University and a Fellow of the Royal Society of Arts. When not reading, writing, or speaking, Montier can usually be found swimming with sharks and blowing bubbles at fishes.

Only White Swans on the Road to Revulsion

The destruction of the US economy, its housing market, its credit markets, its commodity market, and its equity markets has frequently been blamed on or described as a "black swan."

My friend Nicholas Nassim Taleb defines a black swan as a highly improbable event that has three main characteristics: (1) It is unpredictable; (2) It has a massive impact, and (3) *ex post*, explanations are concocted that make the event appear less random, and more predictable than it was.

However, it is wholly wrong to characterize what happened to the US economy and markets as a black swan. To do so is, in fact, an abdication of responsibility. If these extraordinary events were totally unpredictable, then there would have been nothing we could have done to prevent them.

The events of 2003–2008 were not black swans at all. They were "predictable surprises." The term was first coined by Michael Watkins and Max Bazerman. A predictable surprise also has three characteristics: (1) At least some people are aware of the problem; (2) The problem intensifies over time, and (3) Eventually the problem explodes into a crisis, much to the "shock" of decision-makers. As Bazerman says: "The nature of predictable surprises [is that] while uncertainty surrounds the details of the impending disaster, there is little uncertainty that a large disaster awaits."

What evidence do I have that the current mess was a predictable surprise? The *New York Times* ran a fascinating article in mid-December 2007. This noted that, seven years earlier, Edward Gramlich, a governor of the Federal Reserve, had warned that a fast-growing new breed of lenders was luring many households into risky mortgages they couldn't afford. The article also cited the Herculean efforts of Sheila C. Bair, a senior Treasury official, to persuade sub-prime lenders to adopt a code of practice and to let external monitors verify whether they were complying with these standards.

Robert Shiller, a professor at Yale and founder of the investment management firm MacroMarkets, even went so far as to re-issue his 2000 book, *Irrational Exuberance*, with a special chapter dedicated to the US housing market. Even yours truly (not renowned for having my finger on the pulse) wrote a note on June 20, 2005, entitled *Pictures of a Mania?—US Housing Special* which concluded "All the criteria of a speculative mania seem present to me." So a cacophony of Cassandras were clearly warning of dangers, and these dangers clearly existed.

All this discussion about "foreseeing" future risks might seem odd coming from someone who is known to be openly hostile to the notion of forecasting (see The Folly of Forecasting, Chapter 9 of Behavioral Investing). However, I think a clear line can be drawn between analysis and forecasting. As Ben Graham, the original proponent of value investing, stated: "Analysis connotes the careful study of available facts with the attempt to draw conclusions there based on established principles and sound logic."

So the big question is this: What prevented us from reacting to the predictable surprise? I can think of five major psychological hurdles that hampered us in this regard. Firstly, there is an ever-present over-optimism. Everyone assumes that they are less likely than average to have drinking problems, to get divorced, or be fired, etc. It is highly likely that the same over-optimism applies when it comes to predictable surprises; we expect them to affect others but not us.

In addition to over-optimism, we suffer from the illusion of control. This refers to people's belief that they have influence over the outcome of uncontrollable events. For instance, E. Langer has shown (1975, "The illusion of control," *Journal of Personality and Social Psychology*, 32) that people will pay four and half times more for a lottery ticket that contains numbers they choose rather than a random draw of numbers.

The same study demonstrated that people will bet more on a coin toss before the coin is actually tossed, rather than after. Perhaps they believe they can influence the spin of the coin in the air! The illusion of control is exacerbated by information. The more you think you know, the more likely you are to suffer the illusion of control.

So-called risk management techniques have clearly fostered the illusion of control. The idea that, if we can quantify risk, we can also control it is deeply flawed. In fact, we can neither measure nor control risk. Simply by providing a number, we fool ourselves into thinking we are in control.

The third psychological barrier to recognizing predictable surprises is self-serving bias. This is the innate desire to interpret information and act in ways that are supportive of our own interests.

So estate agents are unlikely to tell you that real estate is too expensive, just as companies will always tell you that everything is fine and dandy. A classic example of self-serving bias can be found in a recent Bloomberg story on the ratings agencies Moody's and Standard & Poor's. None of the 80 'AAA' securities in the ABX indices meets the criteria that S&P themselves define. Yet only one of these bonds had been downgraded by S&P, and none were downgraded by Moody's.

The penultimate hurdle is myopia (or "hyperbolic discounting," if you happen to be a geek). This reflects the idea that consequences, which occur at a later date, tend to have much less bearing on our choices the further into the future they fall.

This can be summed up as "Eat, drink and be merry, for tomorrow we may die." Of course, this ignores the fact that on any given day we are roughly 26,000 times more likely to be wrong than right with respect to making it to tomorrow. Or, if you prefer, this myopic bias can be summed up by Saint Augustine's plea: "Lord, make me chaste, but not yet." In a world in which short-term profits are so highly prized, it is exceptionally difficult to focus on the longer-term picture.

The final barrier to spotting predictable surprises is inattentional blindness. This refers to the fact we don't see the things we don't look for. The classic experiment in this area concerns watching a video of two teams playing basketball. One is dressed in black, the other in white, and a person is asked to count the number of times the players in white pass the ball amongst themselves. Half way through the video, a man in a gorilla suit walks on, beats his chest and then walks off. Whilst watching the video, around 80% of people fail to spot the gorilla. Why? Because they were distracted with the task of counting the ball passes.

Bubbles are a by-product of human behavior, and human behavior is (sadly) all too predictable.

The details of bubbles change, but the general patterns remain very similar. Such events are clearly not black swans. Of course, the timing of the eventual burst remains as uncertain as ever, but the events themselves are all too predictable. We have long been proponents of the Kindleberger and Minsky framework for analyzing bubbles. Essentially, this model breaks a bubble's rise and fall into five phases as shown below.

Displacement

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Credit creation

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Euphoria

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Critical stage/Financial distress

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Revulsion

1. Displacement—The Birth of a Boom

Displacement is generally an exogenous shock that triggers the creation of profit opportunities in some sectors, while closing down profit availability in other sectors. As long as the new opportunities created are greater than those that get shut down, investment and production will pick up to exploit these new opportunities. Investment in both financial and physical assets is likely to occur. Effectively, we are witnessing the birth of a boom.

2. Credit creation—The Nurturing of a Bubble

Just as fire can't grow without oxygen, so a boom needs liquidity on which to feed. Minsky argued that monetary expansion and credit creation are largely endogenous to the system. That is to say, not only can money be created by existing banks ("'inside money"), but also by the formation of new banks, the development of new credit instruments, the use of leverage, and the expansion of personal credit outside the banking system ("outside money").

As J. K. Galbraith writes: "As to new financial instruments, however, experience establishes a firm rule … that financial operations do not lend themselves to innovation. What is recurrently so described and celebrated is, without exception, a small variation on an established design … The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version."

3. Euphoria—The Acceptance of the Bubble as Norm

Everyone starts to buy into the new era. Prices are seen as only capable of ever going up. Traditional valuation standards are abandoned and new measures are introduced to justify the current price. A wave of over-optimism and over-confidence is unleashed, leading people to over-estimate potential gains, underestimate the risks, and generally deceive themselves into thinking they can control the situation.

4. Critical Stage/Financial Distress

The critical stage is often characterized by insiders cashing out, and is rapidly followed by financial distress, in which the excessive leverage built up during the boom becomes a major problem. Fraud often emerges during this terminal stage of the bubble's life.

5. Revulsion

This is the final stage of a bubble's lifecycle. Investors are so scarred by the events in which they participated that they can no longer bring themselves to participate in the market at all. Revulsion is characterized by exceptionally cheap asset prices and bargain basement valuations, often bought about by forced sellers.

A through understanding of history and human psychology should better equip investors to understand the warning signs, the opportunities, and the pitfalls associated with the formation of bubbles. But as J. K. Galbraith notes: "There can be few fields of human endeavor in which history counts for so little as the field of finance."

More Info

Books:

- Galbraith, John Kenneth. *A Short History of Financial Euphoria*. London: Penguin Books, 1994.
- Graham, Benjamin. *Security Analysis*. 6th ed. Maidenhead, UK: McGraw-Hill.
- Montier, James. *Behavioral Investing: A Practitioner's Guide to Applying Behavioral Finance*. Chichester, UK: Wiley, 2007.

- Montier, James. *Behavioral Finance: Insights into Irrational Minds and Markets*. Chichester, UK: Wiley, 2000.
- Shiller, Robert. *Irrational Exuberance*. 2nd ed. New York: Broadway Books, 2006.
- Watkins, Michael, and Max Bazerman. *Predictable Surprises: The Disasters You Should Have Seen Coming, and How to Prevent Them*. Cambridge, MA: Harvard Business Press, 2004.

Article:

- Langer, E. J. "The illusion of control." *Journal of Personality and Social Psychology* 32:2 (1975): 211–328.

See Also

Best Practice

- Booms, Busts, and How to Navigate Troubled Waters

Viewpoints

- Viewpoint: Leigh Skene
- Viewpoint: Michael J. Panzner
- Viewpoint: Todd Buchholz

Checklists

- Stock Markets: Their Structure and Function

Finance Library

- The Black Swan: The Impact of the Highly Improbable

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