TOP TRADERS ROUND TABLE

Episode #26

Daniel Crosby

sponsored by CME Group

"If we can follow just a couple of simple rules, we can overcome the behavioral errors which are the plague of so many investors." ~ ***Daniel Crosby***

The following eBook serves as a detailed transcript of Episode #26 of the Top Traders Round Table Podcast. You can find show notes and more information on this episode right here: toptradersunplugged.com/rt26

I sincerely hope these interviews serve as a useful resource for you in your career and endeavors in the world of trading. If you have indeed enjoyed these shows, please consider giving the podcast a rating and review on iTunes. It would help spread this knowledge to traders everywhere.

As you read this transcript, remember to keep two things in mind: all the discussion that we'll have about investment performance is about the past, and PAST PERFORMANCE DOES NOT GUARANTEE OR EVEN INFER ANYTHING ABOUT FUTURE PERFORMANCE. Also understand that there's a significant risk of financial loss with all investment strategies and you need to request and understand the specific risks, from the investment manager, about their products before you make investment decisions.

Niels: Welcome back to another edition of Top Traders Round Table, a podcast series on managed futures. My name is Niels Kaastrup-Larsen, and I'm delighted to welcome you to today's conversation with industry leaders and pioneers in managed futures brought to you by the world's leading futures exchange, CME Group.

Today I'm thrilled to be joined by Doctor Daniel Crosby who is the Chief Behavioral Officer at Brinker Capital, as well as the author of a number of highly recommended books including the book titled, The Behavioral Investor, and the host of the Standard Deviation podcast. First of all, Daniel, welcome, and thank you very much for getting up early to join me for an exploration of the fascinating aspects of investing through the eye of behavioral finance.

Daniel: My pleasure and I've been up for a couple of hours, so, we're good to go.

Niels: Great stuff. Now, before we jump into today's topics, I think it's always useful to frame our conversation with a bit of your own path and how you got to where you are today. Perhaps more so with you because today I find that there are lots of people that see themselves, at least, as experts in behavioral finance, but most of them don't really have the academic roots to fit that title, but you do. You are different in that respect, so, why don't we just go back and talk a little bit about how it all came about, so to speak.

Daniel: Sure, well, it's interesting. I'm very active on social media and being a psychologist who's putting his ideas out in the world, you quickly learn that everyone is an armchair psychologist. Sometimes I wish I were a physicist or something else that felt, maybe, a little bit more unattainable, and maybe people wouldn't have quite so many ideas.

But yes, I am a little bit rare in our industry. I'm a clinical psychologist by education. So, my Ph.D. is in Clinical Psychology. I went to school to become a therapist, and about 75% of my way through graduate school, I was just burnt out.

I enjoyed thinking deeply about why people did the things that they did but knew that I didn't want to be seeing patients, in a medical setting, 40 hours a week. So, luckily for me, my father is a financial advisor, and so my father turned me on to this new field of Behavioral Economics (not so new but new to me), and it was just beginning. This is right when Kahneman is winning the Nobel Prize. So, it had sort of been in the news; it had been topical. So yeah, I got turned-on by virtue of a Dad who was in the industry and could point me in that direction.

So, as soon as I started to learn about behavioral economics and Behavioral Finance, I knew I was home. [To make a] long story short, over a series of adventures and misadventures I have worked myself into a place where I get to talk about and think about these things full-time.

Niels: Yeah, that's great. It's definitely a different path than most. I was just wondering, out of curiosity, do you think that people, without your kind of training (sort of deep-down) might miss something in the advice that they provide to people? Is it that different having all the knowledge that you have from the academic side, I guess?

Daniel: Well, I would say that knowledge is the least important part of it all. I mean, I'm sure we'll discuss, today, that knowledge does very little to change human behavior. One of my favorite examples is that, in the early nineties, here in the U.S., we started labeling our food. You see how much fat and sodium and calories and all that, that's in your food, and since that time, the U.S. population is twice as fat and three times as morbidly obese. So, just knowledge by itself does very little.

For me, having spent thousands of hours sitting across from people who are having the worst day of their life, and training in empathy and training in connecting with people is immensely valuable when giving advice. Knowledge is, unfortunately, not all that valuable.

Niels: No, no, that's true. I mean I guess a lot of the people who do the advice-giving, so to speak, in today's world, they've read other books (Modern Portfolio of Theory and the likes), and whatever you're given when you take your degree in finance. I just wonder if, maybe today, they're not really adequately equipped.

If you don't understand the overriding rulebook of investing, meaning humanity and how we behave. So, to me at least, it seems like it's just an area that should have a much higher place in our industry, so to speak.

Daniel: Well, I'm absolutely with you. I think one of the things that you learn as you study trading, as you study financial markets, is that human beings are, of course, the bottom-most turtle. They're the fundamental element of capital markets, and so I think you're exactly right.

Interestingly, the U.S. has been a little slow, I think, to embrace this. I think Western Europe far exceeded and preceded the U.S. adoption of Behavioral Finance. I'm proud to say that we're catching up a little bit. Yeah, I think this is a bigger deal in Europe, still, than it is here, and it's absolutely the most important thing an investor could study.

Niels: Sure, sure. I want to start in an unusual place, I think at first glance, Daniel, namely with Guinea worms because, in my view and having listened to the things you've done, it ties in perfectly to our conversation today about investing, human behavior, and what good investing behavior looks like. So, I'm sure you know where I'm going with this. So, maybe you can take the lead on this one?

Daniel: I do. So, this is a story I started out my previous book, The Laws Of Wealth with. It's one that tends to stick with people because it's a little bit stomach-turning, but there is a good point. I didn't just include it to be gross.

So, I'm from Atlanta (Atlanta Georgia), and Atlanta is, of course, home to Coca Cola, and UPS, and a couple of other big businesses. But, one of the things that we're most proud of is that Atlanta is the center for epidemiological research in the world. So, I relate the story of The Carter Center, which is the philanthropic legacy of President Jimmy Carter. It's his philanthropic arm. What they did was, for the first time in human history, they eradicated a disease for which there is still no cure. So, it's even... it almost sounds nonsensical when you say it - they eradicated a disease that there's no cure for. It has never happened before.

There's no pill; there's no potion that will get rid of Guinea worms which, at the time, were impacting millions and millions of people in Africa, and just totally decimating economies. Basically, what the Carter Center did was that they trained young people, they trained young students and teachers, to go over to Africa to educate people around the two behaviors they needed to do: basically, they needed to identify the early signs of Guinea worms, and they needed to quarantine because the way that Guinea worms spread is they make your feet itch.

Sorry, we'll get a little gross here.

They make your feet itch and so people would run down to the communal watering hole and submerge their feet in the village water supply to try and get some relief from the itching. Of course, then the worms get into the water supply, and the whole thing goes and goes. So, they identified two behaviors: identification and quarantine. They found that if they did these things, they could eradicate the disease. So, simply by following two rules, they eradicated this disease that was crippling a number of West African nations.

So, the parallel that I draw to investors is, if we can just follow a couple of simple rules, right? If we can just follow a couple of simple rules, we can overcome the behavioral cancers (the behavioral errors) which are the plague of so many investors. Sad to say, there's no pill coming, there's no potion coming that's going to make us rational or make us make good decisions. So, we have to just follow these rules.

Niels: Absolutely. In a sense, you could say, as you say, there are a couple of rules that should be followed. But there is [that time], obviously, when you don't, and you can say that that's the bad behavior. I think you site it in some of your work, something that you called the behavioral gap which talks about the under-performance of people who have bad behavior when it comes to investing. It's fascinating for me to know a little bit more about these behavioral biases and understand them better.

So, just out of curiosity, tell us about this massive challenge (from a 'big picture' point of view) that we, as investors, have and how we can overcome the overall problem of investing with the bad behavior we often see.

Daniel: Yeah, so, going 30,000 feet here, I'd like to say that God, or nature, could not have designed a worse investor than you or I. Every single way that we have evolved - we have evolved for immediacy, we've evolved for certainty, we've evolved for action. Success in financial markets takes dealing with uncertainty; it takes restraint; it takes patience; it takes not listening to your gut. Our gut was our original risk tolerance system [that was] our gauge of how we ought, or ought not to behave. I've made the point (I hope rather convincingly) in my latest book that listening to your gut is a profoundly bad idea.

So, I think the first thing that we need is just recognition and awareness of just how ill-equipped we are for this. I think a lot of people who have had success in other avenues, in other places in life, they go, "Oh, I've been a successful business person, or I'm a successful parent," or whatever it is. They go, "I'm competent; I'm a good person." They think that those skills will generalize into the world of investing. I refer to it as 'Wall Street Bizarro World' in the laws of wealth. The rules of good investing are almost a hundred and eighty degrees [opposite] of the rules of the rest of life. So, in a very real sense, what got you there in other places in your life won't get you to where you want to go in the world of investing.

So, recognition about that and humility around it, and I'll steal... I'll paraphrase Jim O'Shaughnessy, from What Works On Wall Street fame (poorly paraphrased). He says something in What Works On Wall Street to the effect of, "The first thing you've got to do, as a behavioral investor, is to recognize that you are just as susceptible to the same dumb mistakes and crippling behavior as the next person."

So, so many of us read books like mine, with an eye to, "Wow yeah, that's totally my neighbor, or my wife, or whoever." We need to use this thing as a mirror and not as a window onto other's behavior. It needs to be a mirror at which we take a look at ourselves in our own behavior.

Niels: Yeah, absolutely. I also heard him say something along the lines of, "We don't see the world as it is, we see the world as we are." I think it's very poignant. Of course, we, as systematic and rules-based investors, will argue that being a Quant is the best response to overcoming the traps of human biases. But, this also presents other challenges, I think, because it isn't as sexy as being a discretionary global macro investor who can tell stories and make things sound very complex, which are some of the things investors really are still looking for because of their biases, which they don't even recognize because, as you say, that they're wrong. So it's kind of a big ask to say to investors that you really need to defy human nature with all of your experience in this field. How do we best do that in a practical sense?

Daniel: So, I think, if you just had to give one piece of advice for becoming a behavioral investor it would be to be a Quant. There's no other single thing that you could do that would get you further down the road to good behavior. However, I just had Mr. O'Shaughnessy on my podcast, and he talked about the great financial crisis. He talked about investing, as a quantitative manager throughout '07 to '09, and he said that the thing he was most proud of over that time was not his performance but the fact that he never deviated from his rules. He said, in his conversations with other ostensibly quantitative managers, more than 60% of them (so, like two-thirds of the quantitative managers), that he talked to, broke their own rules.

So, again, human behavior worms its way into every facet of this. Being a Quant is a fantastic hedge against bad behavior, but we have to do what Jim Simon said. Jim Simons, of Ren. Tech. (Renaissance Technologies LLC) fame, said, "I set the rules, and I followed them slavishly." Your rules are only as good as your adherence to those rules. So, we have to try and make sure that bias doesn't enter into the creation of those rules and, then, more importantly, we have to make sure that bias doesn't cause us to subvert our own rules just when we need them the most.

Niels: Yeah, I mean, I couldn't agree more. Working, myself, for a firm that now celebrates 45 years as a systematic rules-based firm, I think that's one of the things that I take away from it - the mentorship of our founder and people like Richard Dennis, whom I had on the podcast a while ago who, of course, was the father of The Turtle Project back in the eighties. When you hear people like that talk about the importance of discipline, it just sits really well with you, but it also means that, if you don't have mentors or people to aspire to who can give you that belief and confidence in these rules, it's really hard, as you said, not to be falling into some of these traps.

Daniel: It makes the case if you think about how to... At the risk of being dramatic here, if you think about how you launch a nuclear weapon or something like that, you have to have multiple parties with their finger on the trigger; multiple points of consent to take a drastic step like that, because we know we don't want to vest that power, unilaterally, in one single person. I think Quant managers would be wise to do something similar; one person's moment of panic or indiscretion shouldn't be able to override the whole system. We want to build stop gaps and other preventive measures in there to keep us from doing what is a very natural human tendency to want to disobey those rules at the moment we need them the most.

Niels: I think that's a great point. Now, it sounds like a lot of the solutions we're really looking for are incredibly counter-intuitive to us as humans. I'm just curious, in all of the stuff you've looked at, is there anything that kind of springs to mind as being the most counter-intuitive finding when it comes to the finance and investing, that you've zoomed in on?

Daniel: So, off the top of my head, the one that comes to mind is just that action is the enemy of success. Meyer Statman looked at 19 different countries, and he found that there was a monotonics, so a stepwise correlation between activity and investment performance. So, those who did the worst were those who, ironically, kept the closest eye on the markets.

So, it's a weird thing to say that (no offense to listeners of this podcast or my podcast but) by virtue of caring this much about it; by virtue of listening to podcasts like this or like mine or, reading books like mine, you might actually, weirdly, be on a bad path. So, there's this apocryphal story of Fidelity doing this survey of who did the best, and it was the people who had forgotten they had accounts or people who have died. I don't even know if that's true, but the research is unequivocal that the more you do, the worse your results are.

Again, this is that Wall Street Bizarro World concept, because if you want to get more intelligent, you should read more books. If you want to get more fit, you should lift more weights. If you want to make more money, you should do nothing, next to nothing. It's a very weird thing to try and get your head around.

Niels: Yeah, that's a great example, actually. I was thinking about, from my own point of view, what would I think of as being really counter-intuitive, and I landed on the thing that, when you start out in this industry (and then I guess even before that) when you're always told, "You should buy low and sell high." Then I end up in this trend following world for 30 years and, of course, what we do is we buy high, and we sell low. It's completely the opposite, but it really works.

Now, we kind of dived into a few, sporadic topics right from the beginning, because there are so many avenues to explore with your work, which I find fascinating. But, maybe it's best that we take a step back and we look at some of the building blocks of Behavioral Finance.

I think you nailed it down to (or boiled it down to) four groups of social difficulties surrounding investment making decisions. So maybe, from this starting point, we can define them and talk a little bit about each of them, and then afterward we'll go on and talk about some of the solutions you have identified as well.

Daniel: Yeah, so, one of the things that I tried to do in my last two books... One of the frustrations that I had with Behavioral Finance was there were these larger and larger lists of biases. I think it was approaching about 200 the last time I read it. So, it's not all that helpful to come to a trader, to come to an investor, and to say, "Look, hey, Mr. Investor, there are two hundred ways that you can get this wrong. So good luck." So, what I did, as I looked at these long lists of behavioral biases and cognitive traps and things like this, is I said, "Look, not all of these are all that distinctive."

If you drill down a lot of these load onto one of just a handful of factors, so, I began to look at the literature on investment error with no preconception about how many errors would shake out. I really landed on four. So, we can... I'll list them here, and then we can talk about them in greater depth

Niels: Sure.

Daniel: So, the first was ego, which is overconfidence (written large). The second was emotion or a tendency to trade on our emotions rather than our logic. The third was attention which was our tendency to confuse things that are visceral, or lurid or sort of sexy with things that are likely. Then, last was conservatism which is our tendency to privilege the status quo and be more comfortable with things that we're more familiar with.

So those, I think basically cover 99% of the waterfront — any sort of behavioral error you make just about loads onto one of those four things. The cool thing about it, like you hinted at, is once we have a manageable universe of investor behavioral risk, we can start to design systems that are robust to protect against some of those risks. So, that's why I think it's important to codify and winnow down that universe of bad behavior.

Niels: I'd love to dive into ego, to begin with. Let me read a quote from your latest book, which I find really fascinating, and maybe you can talk to that a little bit more. It goes like this, "If 'this time is different' is the most expensive phrase in investing, I would like to nominate 'I don't know' as the most overlooked phrase in investing, with 'I was wrong' as a close second. As is so often the case the usefulness of these beliefs, in an investment context, is directly proportional to their behavioral difficulty. Acceptance of uncertainty and a belief in personal fallibility are remunerated precisely because they come so hard to humankind. It is strange to consider that many of the most effective tactics in investing have 'I don't know' at the core. Passive investing and (maybe I can, personally, add here, trend-following and managed futures) is the embodiment of 'I don't know' investing."

I think, this is really critical to understanding what this really means because, interestingly enough, one of the key phrases that have really been in our industry for a very long time, since the '80s (I think it was a gentleman called Larry Hite who kind of phrased it back then) is, "Knowing what you don't know." I think this is important. I'd love to hear you diving a little bit more into this part of your findings.

Daniel: So, you mentioned earlier that human desire for stories. So, for much of human history, that's how we connected. That's how we transmit information and connected with each other. Research out of Princeton shows that when two people are sitting across from each other (so you and I are having a conversation), if they take a brain scan of each of our brains, they don't look much alike, initially, when we're having a conversation. Yours is much better than mine.

But then, when I start to tell you a story though, our brain activity syncs up. So, in a very, very real sense, we are hungry for stories; we are wired for stories, and we want stories in the market because it gives us certainty or at least a false sense of certainty. We want the world to make sense. At a fundamental level, we don't want to embrace the chaos of life and markets. So, stories do a lot to sort of soothe our psychic pain. But as you said, a lot of the best approaches to investing, be it trend following, high-conviction sort of Quant value, passive investing, many, many that we could name have 'I don't know' at the base.

We are following rules. We are following rules based on what has worked historically, but we don't know: I don't know who's going to win the next election. I give the example of when Donald Trump won the election, in the U.S., I did not know that. I think nearly no one expected that. It was not as I expected, and when he won (I don't know if you remember) that night the Futures were just decimated. I said to myself, "This is it!" You had Paul Krugman and other esteemed economist coming out and saying, "Well, this is it. This is the end of the American economy as we know it. The stock market is going to go straight to hell."

My rules said, "No." My rules, at that time, were saying, "Stay put." My brain, my expectations, my discretionary sense of risk were all flashing warning signs. But, my rules said to stay invested, and I'm so glad I listened to my rules because of course, we've had a nice run since then notwithstanding recent turbulence. It's just that there's going to be a million examples of this.

It's much more pleasing to be the macro-discretionary guy that gets to go to the conference and weave this complicated narrative about what's going to happen in the Trump presidency. It's much less sexy to be Daniel Crosby, and to go, "You know I don't know." But historically, history tells me I need to stay put. I've no idea what's going to happen.

So, it becomes a problem. It's tough, but you have to convince yourself. Even if you can't convince other people, you have to convince yourself. Dan Egan, behavioral scientist at Betterment, wrote a great piece, recently, about how all investors need a faith. When he compared the different ways of operating within markets to a religion (almost), and said, 'Look it doesn't... you need to believe in something." Whether the something you believe in is managed futures, or value investing, or passive investing, or whatever it is, you need an internal sense of belief because that's what's going to see you through the hard times. So yeah, I never know what's going to happen, but I know I am a market historian, and I know what's happened previously. I feel that I can tilt probability in my favor by operating within those parameters, but it sure is hard to not have a story when you want one.

Niels: Yeah, something I certainly still meet, after all these years and with lots of investors, [is that] you come there, you show them a 20, 30, 40-year track record and they still question, "So, why do you think this works?" At the same time, they will turn on the news media, listen to someone, make a prediction (where we all know that you can't predict the future). So, it's really mind-boggling, sometimes, how difficult [it is] for us to get that message across, really, but there we are. So, that was a bit on ego. Do you want to touch on some of the other ones: conservatism, attention, just to get the whole spectrum of challenges that we have (and there's one more, of course)?

Daniel: Sure, so conservatism comes about for a couple of reasons. Primary among them is that our brains account for about 2% to 3% of our body weight, but they account for about 25% of our metabolic expenditure in a given day. So, just thinking and autonomic processes are accounting for about 25% of all the calories that you burn in a day, even though your brain is relatively small relative to the rest of your body. So it's really, really inefficient, and your body is always looking for ways to shut your brain down and not use so much damn energy.

So, one of the ways that we do this is we just go with the tried-and-true; we go with what's always worked before. We go to the grocery store, and we don't re-evaluate every decision about what kind of peanut butter to buy. We just buy what we bought as a kid because it's familiar. We don't have to think about it, and you see this in investing too.

You see this in things like people's unwillingness to re-evaluate a cherished position. You see this in a home country bias. As a general rule of thumb, a balanced portfolio should have an allocation to countries that is roughly consistent with their size in the world economy. But, I lived in Canada for a time. Canada makes up about 4% of the world economy. The average Canadian has about a 60% allocation to Canadian stocks.

It is tricky too because you're effectively triple stacking risk. Your house is in Canada, so that's Canadian real estate exposure. Your job is in Canada, and you're already exposed to the economy of Canada there, and now you're going to load the boat with Canadian equities too?

I'm not picking on Canada. Everybody does it. It's just it's a bigger or smaller problem relative to how large your country is. So yeah, it's this problem of that we just settle for what we know. Living here in Atlanta, we've got Coke, and UPS, and Aflac, and a couple of other Fortune 500 companies, and I'll meet people who have 80% of their net worth in a single company - [I question], "What are you doing? Think about Enron; think about GE." And they go, "Oh, I know, I know what goes on there." You go, "Okay, you're one of three hundred accountants at Coca-Cola. You are not materially impacting the stock price. You do not know what's going on there."

So, we have to overcome this and be willing to take smart risks, and to think outside the box, and to look at asset classes, and country exposures that we may not be familiar with. We need to take efforts to familiarize ourselves with those things.

Thanks for tuning into Top Traders Round Table!

Ready to learn more about the world's Top Traders? Go to TopTradersUnplugged.com and signup to receive the full transcripts of the first ten episodes of the Top Traders Unplugged podcast, as well as full access to show notes and useful resources to all episodes of both the Top Traders Unplugged AND Top Traders Round Table podcast series.

We have some amazing guests lined up for you, and to ensure our show continues to grow; please leave us an honest rating and review on iTunes. It only takes a minute, and it's the best way to show us you love the podcast.

We'll see you on the next episode of…

TOP TRADERS ROUND TABLE

Sponsored by

CME Group

© 2019 Top Traders Unplugged