TOP TRADERS ROUND TABLE

Episode #27

Daniel Crosby

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"Emotion overrides cognition pretty dramatically." ~ ***Daniel Crosby***

The following eBook serves as a detailed transcript of Episode #27 of the Top Traders Round Table Podcast. You can find show notes and more information on this episode right here: toptradersunplugged.com/rt27

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 Top Traders Round Table a podcast series on managed futures, brought to you by CME Group, where I continue my conversation with Dr. 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 host of the Standard Deviation Podcast.

The fourth one that you cite, which I often think as being the biggest one, or maybe the one (at least in our industry) we talk the most about when we talk about why it makes sense to consider managed futures or trend following, and that's emotion. It's such a big. Maybe you can talk a little bit more about it. I also spoke with Andrew Lo, on the podcast, and he has also talked about the challenges with emotion. I'd love to hear your thoughts about this area as well, and what you found to be the key points when it comes to dealing with emotions, as an investor, I guess.

Daniel: Yeah, the Andrew Lo episode was great. I listened to that, and I'm a big fan of his work. So, emotion is interesting because emotion overrides cognition pretty dramatically. So, when you look at studies of investors who are under duress, like investors who are under stress, we find that they lose 13% of their cognitive capacity. So, effectively, 13% of your I.Q., and you got to think that some of us don't have 13% to give. We need every last shred of brainpower that we've got.

So, emotion overrides that thinking, and it causes us to make poor decisions. There are a couple of things we can do around emotion. The first is to be a Quant: to, basically, automate doing the right thing and set in place the stopgaps that we talked about earlier. I think learning about emotion, and learning to handle it (because I think things like trend and momentum, and other things actually ride with human emotion), you can use human emotion in your favor. I think there are some examples of even ways that we can do that from an investment standpoint and in saving and planning for our financial lives.

I cite a study, in my first book, that talked about low-income savers, who looked at a picture of their children before making a financial decision, save two and a half times as much as those in a control group. So, if you're a trader (if you're an investor or trader), why are you doing this? Why are you doing this? [It's about] using that emotion to keep you focused on your 'why' and, hopefully, having that keep you focused on your rules.

So, emotion cuts both ways. Emotion can be used to our benefit or to our detriment, but I think if we keep that 'why' front-and-center, there's a lot that we can do to keep our head in the games. But, more than anything, overcoming emotion is just about automating, just about automating.

This is where it gets tricky because a lot of people want to have goals. They say, "Oh, I'm going to have a goal to control my emotions, and I'm going to work, I'm going to meditate, I'm going to pray, I'm going to do whatever I do to try and control my emotions. I'm going to exercise." Those are all good things, but you don't need goals. Everybody has a goal. You need rules.

The best example I can think of is New Year's Day. Everybody has a goal to lose 20 lbs. You don't need a goal. Every idiot has a goal. You need rules, and the rule is I go to the gym 4 days a week.

It's the same thing with investing. Everybody has a goal to keep their head; to stay emotionless and calm. Don't have a goal. Every idiot has a goal. Have a rule that, "I don't do X, Y, and Z; I do A, B, C." So, it's rules, over goals, all day long.

Niels: Yeah, absolutely. So, we talked about the default key behavioral risks or biases, and we also touched on, a little bit, about some of the solutions. But, just for the benefit of our listeners, I want to talk... Because, you very neatly put it into something you call the 'four Cs' (although, my wife told me, when we got married, that the 'four Cs' has a completely different meaning). So, now I'm confused here.

Daniel: Color, Cut. Clarity, and what's the other one? Carat?

Niels: (laughter) Yeah that seems to be front-and-center as well. So, your 'four Cs' are a little bit different. So [yours are] Consistency, Clarity, Courageousness, and Conviction. I'd love to spend a little bit of time on each of those, because I think this is where we can, hopefully, help our listeners today. Because, as you say, we're prone to these biases, but there are ways to handle them better than what we would normally do. So, why don't we just jump in and start with Consistency and what you think about when you use that as a way to overcome.

Daniel: Sure, so, Consistency is, again, around automation and being a rules-based or systematic investor. So, the best example I can cite, here, is a meta-analysis (a meta-analysis being a study of all of the studies), so this meta-analysis of following simple rules versus relying on Ph.D.-level human discretion. So, do you just follow the rules, or do you get a group of experts to make a decision?

They looked at over 200 studies, and they found that 94% of the time simple rules met or exceeded the level of decision-making by a group of experts. This has nothing to do with cost or headache or time spent. Obviously, the rules save you on cost and headache, and time spent.

This cut across everything from stock picking, to medical diagnostics, to prison recidivism studies. I think the prison recidivism study is fascinating. In the U.S. we have a crazy problem. One percent of our population is in jail, which is its own podcast. That's insane. But, 1% of the American population is in jail, and so we have to come up with ways to decide who gets set free and who has to stick around and keep on learning their lessons.

So, what (historically) we've done is we get groups of people like me - big brains with good degrees. We say, "Okay, you three doctors of psychology, you sit across from this prisoner and determine whether or not he's repentant, whether or not he's reformed and he's ready to be back in society." So, that's column 'A.' Column 'B' is looking at things like: How did they act in jail? Were they well-behaved in jail, and what were they in for? Were they in for possession of marijuana? Are they in for rape and murder?

So, by just looking at the two behaviors: what are they in for and how did they act in jail? That was three times as effective as paying a panel of experts. The same thing is true of stock picking and portfolio construction. We see again, and again, that following some simple rules is better than paying a team of CFA's (sorry CFA's). Get the CFA's to make the rules; get the CFAs to staff the rules.

But, we don't need some complicated investment committee making up their own stories or trying to use their own discretion. We need good rules based on probability, based on the way the capital markets behave over time. So, with Consistency, you're going to get better results for less time and less money. It's an incredible deal.

Niels: Let me just add, for all the listeners, by the way, I definitely encourage you to read your books, and in particular the one that I cite in the beginning, The Behavioral Investor, because what you do, actually, is also that you make it very practical. You have a few key points at the end of each topic, so to speak, which I find really, really useful.

Now, Clarity, and it goes a little bit with what you just said before: "Simplicity is the ultimate sophistication," as Leonardo DaVinci is quoted in your book for having said. Do you want to add something? Where does Clarity become a little bit more important, perhaps, in terms of investing?

Daniel: So, you know, I have a different job now, but for a while there I was involved in the creation and sale of these sort of behaviourally informed investment strategies. The most common criticism I got, when trying to market these things to institutional investors, was, "It just seems too easy," "It's just too simple." "Where is the complexity?" So, as my friend Dr. Brian Portnoy says, "We have this fetish for complexity in the world of financial services and its really, really misguided."

So, let me give you a couple of reasons why that's the case. The Fed, the U.S. Fed releases 45,000 pieces of economic data each year. Okay, that's insane - 45,000 pieces of economic data. If you regress all 45,000 of those variables against each other, do you think you're going to come out with some things that are correlated? Yeah, of course you are. You're going to find some signal there, but it may not really be signal.

So, we have so much information now, that there's so much noise out there, that if we're not careful if we're not adhering to this dedication to simplicity, we can find signal where there's just noise. So, to give a couple of examples: there's the famous one about Bangladeshi butter production being 96% correlated with moves in the S&P 500.

But, are you and I going to go start a Bangladeshi butter production hedge fund after this? Probably not, because in order for a signal to make sense it needs three things. I talk about this in The Behavioral Investor. You need data, of course. You know it needs to show up in the data. That's a given. But most people stop there. Most people stop there. The second thing you need is you need a theory: why might these data be there? Because, that kills your Bangladeshi butter production hedge fund right there: you go, "Okay, it's in the data, but it makes no sense." There's no good philosophy; there's no good theory as to why this might be the case. Then the third thing you need is behavior.

Signals that endure: things like value, things like trend, and carry, and these sorts of things, they all have a behavioral component to them which is why they endure. Because, if you look at the history of market anomalies calendar effects, and different things that don't have behavior to them, they get discovered, and then they get arbitraged away as quickly as they get discovered. So, a good signal is simple, but it has data, it has theory, and it has behavior somewhere in there because bad behavior is forever. Behavioral tendencies go on forever.

I don't care how many labels you put on a candy bar I would bet on the American public eating candy bars from here until eternity. You can't put enough warning labels on them to discourage that behavior.

Niels: I think there are lots of fascinating things you talked about. Just to comment on the last point you made about behavior, that's exactly what Jeff Bezos did, and how he built Amazon. There are certain behaviors: we want things as cheaply as possible, as quick as possible, and those are the behaviors that he's exploiting very well, it seems. But I think the other thing that you quoted there, or mentioned, that, I think, is really interesting is this massive amount of data and how we are fascinated with it.

What I see in our industry, right now, is the word 'big data.' Some people are just suckers for even more data. Even though we come with our trend following strategies, for example, [and we've] done it for decades. We use open high, low close - that's all we need. It really doesn't sound very sexy or very complex, and it's not, but it works.

But, it's just not what people want to hear. They want to be... You know, being Danish, I'm familiar with Hans Christian Andersen. It's kind of the Emperor's New Clothes. I mean, it's really, really interesting, really interesting.

Daniel: The greatest philosopher of all time is Danish. I tried to name my son Søren after Kierkegaard, but my wife wasn't having it. So, a shout out to the Danes.

Niels: Shout out to the Danes. Yeah, maybe not so much from the White House right now with Greenland in play, but there we are. That's for another podcast, I think.

Courageousness, we, in our world, feel very courageous when we follow our rules every day. What do you think of when you think about Courageousness?

Daniel: So, Courageousness is, again, automating the process of doing what makes sense with your head but is almost always going to feel wrong with your heart. So, the tricky part about being a behavioral investor is you almost always feel stupid. You almost always feel like you're doing the wrong thing. Now, you're going to be rich and feel stupid, so, that's a good trade-off. But, feeling comfortable, and doing the right thing, have almost no overlap in financial markets.

The right thing to do is, very seldom, the easy thing to do in financial markets. So, that piece is, really, all about automating the process of doing the dirty work. So, there have been studies that show (physically, not just psychologically) that doing things like being a contrarian investor is physically painful.

We don't have separate sensors for psychic and physical pain. Pain is pain, is pain. So, they do studies on people who've lived through the great financial crisis. They have PTSD like symptoms (post-traumatic stress disorder type symptoms). [They] do studies on high-conviction contrarian value investors, and they show signs of social isolation. So, being a behavioral investor is a bit of a lonely road. So, that chapter just talks about the courage of automating that process and then understanding that if you feel crummy, if you feel alone, if you feel like you're crazy, you know you're going to, and you might be onto something.

Niels: Yeah, absolutely. I guess it ties in quite nicely with the last 'C,' meaning Conviction, and the need to do these different things in order to succeed, and just a belief, I guess, to follow the rules every day. How would you frame Conviction in a more sophisticated way?

Daniel: So, with Conviction, there are two things that you need to be successful, as an investor. You need to have a unique opinion, and that opinion needs to be right (a small detail). You need to express a unique opinion that needs to be the correct opinion.

So, there has never been a better time in the history of the world to be an investor. If you are the average saver, with a modest income, and you just want to diversify, and set it and forget it. There are a host of wonderful, low-cost indexes and other options that are available to you, and you can be very successful that way.

But, I write my books for active investors. I write my books for people who are trying to beat the market. So, this is just saying, look, if you want to do this, if you want to play this game, you need to have Conviction. You need to find the 'sweet spot' between diversification and Conviction, and express a unique opinion. 75% in the U.S. (I don't know what it's like internationally), in the U.S., when you look at mutual funds that are labeled active, 75% of them don't differ meaningfully from their benchmark.

So, what you have got is a lot of people charging high fees for very little courage, very little Conviction, very little in the way of a unique opinion. So yeah, my advice here is, look, there are more important things in the world than investing; there are more important things in the world than making money. So, if you just want to index your money and go watch your kids baseball game, that's a great way to live, go do that. But, if you're going to play this game, if you're going to be crazy like you and I are, and try and play this game, then you need to express a unique opinion, and you need to be brave enough to do that in a high conviction way or don't bother.

Niels: Yeah, absolutely, perfect. Now, we've been through the key points, and people should go and buy your book so they can get all the details, but there's a couple of more random topics, or maybe statements that I wanted to run by you as we slowly start to wind down our conversation and just to hear you talk about them through your lens. The first one that comes to mind is this thing - process over outcome. Tell me why this is important when it comes to investing.

Daniel: So, my friend Annie Duke is a poker player, and she's written a great book called Thinking And Bets, and she refers to this as 'resulting.' All the time, we work backward from the results or the outcomes of something, and then decide, post hoc, whether or not it was a good decision. Being a good investor means you have to work in the opposite direction. You need to follow a process.

So, your man, Kierkegaard, said something to the effect of, "Life can only be understood looking backward, but it must be lived moving forward." So, that's what we have to understand.

We have to do the right thing, follow the right process even though it's not going to always end in the outcome that we want. I shared a Tweet this week. There was a gentleman in Italy, I believe. He put $100,000 (He was playing craps), he put $100,000 on whatever it was (I don't gamble), so red 25 or whatever it was. It hit (sorry, roulette rather), and it hit. So, he won three and a half million dollars on his $100,000 bet. So, you look at that and go, "Did that guy make a good decision?" You ask the average person, "Did this guy make a good decision?"

And the average person on the street will say, "Yeah, yeah, that's a great decision," because he won three and a half million dollars on this. The behavioral investor understands that you can get the right outcome and still be a moron. That guy is still an idiot even though he won.

You have to evaluate the decision based on its probabilities and not on the outcome. That's a very, very tough thing to do. Most people think that guy is a genius when really he's an idiot.

Niels: Yeah, and I love Annie Duke's work as well. She has definitely written some great books and talks a lot about that. I think, in particular, there's a football incident in the Super Bowl that she cites, which also is fascinating, about whether that was the right decision or good decision to make.

I also wanted to ask you about this one. It's something that only goes against human nature, namely, in order to be a good active investor, we need patience and persistence and paying zero attention to all the noise.

Daniel: If you look at the predictors of moving human behavior... I like to put things in groups and make them alliterative. You may have noticed with my 4 'C's.' If you look at the things that move human behavior: we've got education, environment, and encouragement. So, with respect to the noise, I think we need all three things.

We need education. We need to educate ourselves on how to be informed consumers of financial media. When I started my career as a psychologist, the first group of people I worked with was women with eating disorders. So, one of the things that we would do, when you're educating a young woman who has an eating disorder, one of the first things we would do is educate her around the media and how models are airbrushed, and there's makeup, and it's not real. What are they trying to sell you? Why are they doing this? How did they get these unrealistic beauty standards?

We need to do the same thing with financial media. Most Financial media is not put out in the world for you or I to make a profit. It's to get clicks and eyeballs, and so we have to really understand the base motives of the information that we're taking in; understand who is selling us good information and who is selling us hysteria.

The second thing we need is the right environment. For many people, the right environment is going to be abstinence. The same way that you would tell an alcoholic not to go hang out at a bar, you would tell the average investor, "You're going to want to leave a lot of this alone. You're not going to want to watch the news every day. You're not going to want to look at your statement 15 times a day."

Robin Hood, the free trading platform here, based in the U.S., they just came out with some information about how often their average user is checking their account. I'm going to mess up the exact number, but it was multiple times a day. For the average person that makes no sense and you're just scaring yourself. So, it's the wrong environment.

The third thing we need is encouragement. So, for the average person, that might be a financial advisor. For a trader that might be a coach, that might be something as simple as your podcast; just checking in every week, getting encouragement, getting new information.

You need all those things. You need to educate yourself on the right thing to do. You need to put yourself in the right environment so you're not tempted to latch onto noise that you shouldn't be attending to. Then, you need a coach, or you need a support system of some kind to help keep you on the straight and narrow path.

Niels: The last statement I wanted to get your view on... I think it's a big one because I think it's incredibly misunderstood, often, and that is volatility can be our friend and volatility is not the same as risk. Help us understand that one.

Daniel: Yeah, so, there are so many reasons why that this is the case. For the long-term investor, think of it this way... I mean, for the short-term investor there are just vehicles: you can use straddles, and different things and volatility can, very directly, be your friend.

But, for the average investor you've got to think that, over the last 35 years, in the U.S. market, the average intra-year drawdown has been 14%. So, we get a correction every single year, on average. We get a bear market every 5 years or so, on average, and we get a correction every single year, and yet the market is ended up 27 of those 35 years.

So, it baffles me that every time there's a hiccup in the market, we lose our minds. In the U.S., here, we're what, 3% off of the all-time highs and we're having cable news specials on markets in turmoil. It's absolutely ridiculous. It happens as regularly as your birthday or Christmas, and yet every time it happens, we're surprised.

So, for traders, there are all sorts of ways in which volatility can very directly be your friend by trading the VIX or using straddles or different things. Even for longer-term, more fundamental investors, volatility is a buying opportunity long-term. It's very normal. We shouldn't act like it's a big deal when it comes around, and it represents a long-term buying opportunity.

I just don't know how to say to people, more directly, that this is the price you pay. The reason why investing in capital markets pays you well is because they're uncertain, and that is the price of admission. It's just part of the game, and the more that we can embrace that fact, and run with it, and even learn to love it (I don't mean to use a German word, but I'm going to mess up this German word here but Schadenfreude). We need to cultivate a deep sense of Schadenfreude so we can actually be thrilled when things are going bad in the markets. I'm there, and I want others to be there with me.

Niels: Yeah, well said, well said. As we start to wrap up our quite wide-ranging conversation, I want to just come back to you, one last time, to talk about when you look at all the research you've done, and you're trying to put something out there which is as practical as it can be, are there one or two things you find that investors can do, today, next week, to start the journey of becoming a better investor and getting the behavior on their side rather than against them?

Daniel: The first thing that I would encourage folks to do (going back to the religion comment), I would encourage folks to read widely and find their faith. So, there are lots of types of investing, some of which are very dissimilar, that all work. Trend works, carry works, value works, wide diversification works. Read until you find what's consistent with your belief system, with your worldview, and find a system that you love.

For me, it's this combination of value growth momentum. As Wes Gray says, "Buy 'em cheap, by 'em strong, hold 'em long." That's the way that I do it.

For other people, they don't love that. So, find the time-tested empirically validated system that speaks to you. Find that faith and then automate it. Then lock it in, lock it in and then go move on with your life. Go do more interesting things than worry about financial market stories. So yeah, finding that system that speaks to you on a personal, visceral level, and then creating a system that locks it up and frees you up to do more important things, and frees you up to go make money. Nothing is going to... Your personal income is still the best trade you'll ever make. So, that's what I would say.

Niels: Sure, very good, indeed. Now, it's not every day (if I can put it this way) that I have a real shrink on the show, so I wanted to ask you a couple of, maybe, personal questions. I'm sure you used to ask people very personal questions. So, if you don't mind, I've just got a couple of things that I wanted you to try out on you. The first one is if you can finish this statement, and that is, "I know I'm being successful when... When do you feel successful?

Daniel: So, I know I'm being successful when I'm reading my kids a bedtime story. So, for me, my job takes me away from home more than I wish it did, not a ton but more than I wish it did. So, for me, money, success, all of this is just a way to get more time with my family. So, that's when I know I'm being successful when I'm spending time with my family.

Niels: Yeah, very nice. Now, you have studied all these behavioral biases, and so on and so forth, is there one particular one that you find the hardest to deal with, yourself, so to speak?

Daniel: So, if you're asking me if I'm arrogant, I am. No, to me, for me personally (and I think, maybe, for most people, which perhaps is projection) I think that that ego or overconfidence is sort of the mother of all biases because I think it's a bias that enables the other biases.

When we think of ourselves as smarter, or luckier, or better-than-average, we lack the humility to do the work to combat the other biases. So, for me, ego is the bias that enables every other bias. Then, conversely, if you can be low ego if you can be humble about your shortcomings and you fallibilities, the other stuff, the other Dominos sort of fall. So, both for me personally and for the average investor, I think ego is the big one.

Niels: Yeah, I couldn't agree more on that. The final question, just on a personal level, are there any kind of habits or rituals that you do to achieve your own goals or dreams that keeps you even on your path?

Daniel: So yeah, I will say that one that I have picked up recently is lifting weights. So, one of the... The first part of The Behavioral Investor we talked about lots of great things. We didn't talk about this that much. I talk about the physiological aspects of investing. I feel like this is under-covered. So, most traders wouldn't think of things like, "What did I have for breakfast?" or "Did I lift something heavy or use my body today?" as very consequential in terms of how successful they are as traders. I would tend to disagree with that.

I think I make a case for that in the book, in a more scientific way. But yeah, just lifting weights, going to the gym has been something that has brought me a lot of mental peace. If you meet a psychologist, you can just about be assured that they're crazy. None of us, none of us, none of us goes into this profession... I should say, rather, we all go into this profession to figure ourselves out first. If you meet a psychologist, almost necessarily, they're messed up, and I definitely fall into that category. So, for me, going to the gym, lifting weights is a very positive way to improve just the noise between my ears, as well as the financial decisions that I make.

Niels: Yeah, we know, of course, from other stories that people like Ray Dalio who is, of course, incredibly successful, for him, it was meditation. I have certainly had other successful managers on the podcast that cite meditation, as well, as being something that they actively use every day. So, I think that is a good point. I think that it is, actually, underestimated, that whole physiological side of things.

Before we finish, I also wanted to ask if you had any final thoughts? Is there something that you feel I have missed, given the fact that we have only got an hour or so? Is there anything that you want to bring up as a final important thought, point in our conversation, Daniel?

Daniel: So, you've done a wonderful job. I feel like we've covered a lot of ground. I would just say that I hope that people who listen to this and choose to read my book or a book like mine about behavioral finance will approach this holistically. I think that markets can teach us lessons about ourselves, and I think that the lessons that you can learn on the way to being a better trader can also make you a better spouse, can make you a better parent, can make you a better neighbor.

So, the study of capital markets is really the study of human behavior. So, as we approached it in that light, it has the ability to make us not only wealthier but to make our lives richer as well. So, I hope that people will take it up with that in mind.

Niels: Yeah, very nice. Daniel, thank you so very much for sharing your thoughts and opinion on today's topic. I really appreciate your openness during our conversation, and even though I feel we've only really scratched the surface of your work, and I encourage everyone listening to dig a lot deeper into your work, I find it so important to have practitioners like yourself to share these ideas because when ideas become conversation that leads to action and that's when real change happens.

To all of our listeners around the world, let me finish by saying that I hope you were able to take away something from today's conversation onto your own investment journey. If you did, please share these episodes with your friends and colleagues and send us a comment to let us know what topics you want us to bring up in the upcoming conversation with industry leaders in managed futures.

From me, Niels Kaastrup-Larsen, and our exclusive sponsor, CME Group, thanks for listening, and I look forward to being back with you on the next episode of Top Traders Round Table. In the meantime go check out all the amazing free resources that you can find on CMEGroup.com as well as TopTradersRoundTable.com.

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