



## How to Think about Investing

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*This introductory article is intended for the educated layman. It was written originally to introduce a continuing series of essays on a variety of investment topics.*

Benjamin Graham (1894-1976), the father of modern securities analysis and portfolio selection, wrote, "To invest intelligently in securities one should be forearmed with an adequate knowledge of how the various types of bonds and stocks have actually behaved under varying conditions..." Graham was a wiser investor than I, but I should add to his statement that intelligent investing also requires that one think about the process in a structural way (as he did), as if you were a scientist. Investing requires both knowledge and an intellectual framework.

Many people mistakenly think that investing, like life, is one damn thing after another. This limited outlook can manifest itself in either of two ways. On the one hand, it leads some to believe intensely that the proper way to invest is to pick stocks or other investments that parade as winners—and lest I seem disparaging, let me add that picking investments that subsequently win is wonderful—and often to believe that these stocks can be identified in advance through intuition or cursory attention, which is a dubious proposition. On the other hand, it leads some into a sort of financial existential despair, and the belief that all investing is a gamble—once again, there is an element of truth here—with the consequence that they fail to take proper care of their financial assets.

When I say that an investor should think about the investment process in a structural way, I do not mean merely that she should have a "system." To me, a "system" is the sort of gimmicky set of rules, founded more on blind faith than on analysis, that one might find in a paperback sold at airport newsstands to new arrivals in Las Vegas or Reno. Rather, one should have an explanatory model of why investments behaved as they have done historically or as you think they ought. This is the way economists think. Having evidence that the model can explain investment performance that occurred in the past also helps.



Graham wrote the first edition of his second famous book, *The Intelligent Investor*, in 1949, moments before the beginning of a revolution in finance, when economists began concertedly to wrestle with financial markets and financial instruments. (Graham's first book, well known to all investment managers at least in name, was *Securities Analysis* (1934).) This revolution, one of whose principal products was what is often called Modern Portfolio Theory (MPT), has had profound implications for how professionals today manage gargantuan amounts of money. Modern financial theory, partly in recognition of its established status, but more because of its relationship to neoclassical economics, has become known (at least among economists, but not the public or even the investment profession) as "neoclassical finance." After more than fifty years, Modern Portfolio Theory is far from modern, and we have also completed a circuit, but not a closed one, during which academically trained investment practitioners have rediscovered all the caveats with which the economists originally hedged the assumptions that underlay MPT and the rest of modern finance.

Moreover, even many financial economists, not to mention, of course, the more *au fait* investment practitioners, have rediscovered some of the virtues, or at least the virtuous investment results, of practitioners who have followed in the footsteps of investment analysts like Graham, like Warren Buffett.

The omissions and limitations of modern financial theory, however, provide no reason to revert to an earlier mythological approach to investment selection and portfolio construction. That would be much as if (to choose an analogy that is readily before us), because of Darwin's ignorance of genetics and apparent inability to explain all aspects of life, we were to reject his ideas and to revert to a theory of life first developed in the ancient Middle East and dressed in the early nineteenth-century clerical garb of William Paley's natural theology or "intelligent design." Modern financial theory contains deep truths, even if its initial articulation was too simple, and it needs constantly to be put to the test and extended. And the founding thinkers were more careful than the textbooks that popularize their work.

In recent years, a more thoughtful challenge to neoclassical finance has come to prominence. It is known as "behavioral finance." At its best, behavioral finance uses rigorous statistical methods to find ways in which individuals and financial markets consistently behave that are inconsistent with neoclassical finance. It also reveals systematic errors of judgment that lead to poor results for investors. At its worst, it devolves into a sort of pop psychology and "just so" stories to explain supposed investment successes. In this form, it is used by some of the more unreconstructed traditional investment managers to spin plausible tales to justify their unproven investment methods to the public and their claims of being able to take advantage of irrational market behavior. The MIT economist Stephen



Ross, in his spirited defense of neoclassical finance, counters the enthusiasts of behavioral finance with four objections:

1. Its observations are of effects that are generally small;
2. The statistical tests that it uses are suspect;
3. The effects it finds are fleeting and tend to disappear once they are discovered;
4. They are not easily used as the basis of a functioning strategy.

In a sense, “behavioral finance” is a misnomer. All of finance, and for that matter, all of economics, ultimately concerns human behavior. All investing, even for the neoclassicists, fundamentally depends upon the ways in which human beings react to the prospects of rewards and risks. When the knowledgeable use the word “behavioral,” they refer to behavior that departs from *consistent rational* behavior. (Some therefore speak of “bounded rationality” instead of “behavioral.”) The greatest value of the field of behavioral finance for individual investors, therefore, lies not in providing special formulas that can help to “beat the market,” but rather in helping them to avoid common errors that produce worse performance than the market.

One consequence of thinking in a structural way about investing is to pay greater attention to the portfolio as a whole than to its individual components. It also allows us to compensate for some of the regular and irrational errors that researchers in behavioral finance have observed being consistently committed by investors. I will have more to say about this in future newsletters.

At this point you ought to know where I stand: My sympathies are with the neoclassical financial theorists. After all, I was educated in finance at the University of Chicago. But I have been an investment practitioner for more than twenty years, and I temper theory with experience. And in handling the portfolios of individuals, I am tilling fields where the theorists, in their ideal and perfect shoes, have feared to tread (at least until the last few years) but investment advisers have been laboring throughout modern history. This is why I emphasize the importance of the structuring of portfolios. You will seldom find me bloviating on the performance of individual stocks. Even Benjamin Graham, writing before the advent of modern portfolio theory, asserted that the concept underlying his approach to security selection, which he named “margin of safety,” is logically connected to the principle of diversification—in other words, portfolio construction.

You may think that I am addressing esoteric disagreements among investment practitioners that have little relevance for your portfolio. But these ideas have practical consequences. There are both subtle and broad disagreements among investment practitioners, and some of these most assuredly have relevance for



your own investments. John Maynard Keynes famously wrote that “Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.” Practical investors who fail to think systematically about what they do are usually the slaves, too, of some defunct investment commentator.

And why am I telling you this, and what are the practical consequences for you, the investor?

If all that mattered in investing were the selection of winning stocks, all of us should be holding the same set of stocks. All our investments would be alike. But they are not, and they should not be. What matters most is the structuring of the portfolio. And the portfolio should be structured to suit the investor. Investment managers are charged with the management each portfolio to fit the particular objectives and circumstances of each client.

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