Are You Too Smart for the Stock Market?

Meet Walter and Victor. Two guys in the investment field.

Victor was a Harvard grad and then earned a Ph.D. from the University of Chicago. He was a finance professor at Berkeley but later left academia to work professionally as a money manager. Oh, and while he was doing all of this, he was a world champion squash player on the side.

Walter did not attend college, but he entered the investment field as a runner when he was 18. After working his way up the system over 22 years, he eventually founded his own money management firm. He did not have an office of his own, so he sub-let a desk at the office of a larger firm. He sat in a small space between the front door and the water cooler, so any time someone came by to get a drink, Walter had to stand up to allow them access to the tap.

Which one do you suppose had more success in the stock market? You can probably guess where this is going, but let's take a step back before we see how their respective careers turned out.

Too Smart for Their Own Good

"I can calculate the movement of the stars, but not the madness of men."
--Isaac Newton

Bubbles are nothing new to the world of investing. While our memories recall most vividly the recent bubbles of residential real estate from six or eight years ago and technology-related stocks fourteen or fifteen years ago, there have been plenty of others over the centuries.

The South Sea Company started out the year 1720 trading for around 130 pounds per share. By February, its price had risen to 175 for a quick gain of about 35%. Then it soared to about 330 in March for another nearly 90% gain. Attracted by the seemingly easy profits, investors began clamoring for shares, bidding the price higher and higher, eventually capping out at about 1000 pounds in August.

Somewhere along the way, Isaac Newton himself got involved. Yes, that Isaac Newton: author of *Principia Mathematica*, co-inventor of calculus, developer of the law of universal gravitation, and basically one of the smartest humans ever to walk the planet.

You might know the rest. South Sea Company stock took a steep and nauseating nose dive, eventually closing below 100 by the end of 1721. Newton and many other people lost their shirts, parliament held an official inquiry to look into the matter, and people were generally fearful of stock investments for a while after that.

All of which makes us wonder….. if one of the smartest people in history doesn't know how to do it properly, what hope do any of the rest of us have for success in the stock market?

Our favorite investment thinker, Warren Buffett, has learned that raw intelligence is not all that's needed to be a successful investor. He has been known to say that investors with genius-level IQs of, say, 140 won't necessarily do better than investors with above-average IQs of, say, 120. For Mr. Buffett, once an investor gets to a certain base level of intelligence, the most important quality necessary for investment success is temperament.

Temperament is Key

Which reminds us to check back in with our friends Walter and Victor.

Can you guess what sorts of temperaments these two investors had? If you had to choose either the champion squash player from Harvard or the no-college guy sitting behind the water cooler, which one do you think would have a temperament better suited to dealing with the wild vicissitudes of the stock market?

Walter Schloss managed his clients' investments from 1955 through his retirement in 2003, a period of nearly five full decades in which he racked up an annualized after-fee return of 16% as compared with the market's returns of 10%.

Victor Niederhoffer has managed to spectacularly blow up on two separate occasions. The first came in 1997, when the Asian financial crisis combined with a one-day 500-point drop in the Dow forced his firm out of business and caused him to have to re-mortgage his house and sell his antique silver collection. He set up a new fund in the early part of this century, and he quickly racked up some impressive gains. By some accounts, the fund grew by 50% per year for five years. That is an incredible result, but the problem is that he then lost 75% of it and his fund was forced to close in September 2007.

Rein It In

So what's a smart person to do? If you are a highly intelligent person wanting to do well in the stock market, how can you make sure you end up more like Walter and less like Victor?

We have two recommendations. First, practice self control. You may have heard about the experiment run by Walter Mischel at Stanford, where he placed a marshmallow in front of a pre-schooler and then left the room. The deal he made with the child was that, if the marshmallow was still there when he returned to the room a few minutes later, the child would be granted a second marshmallow. From the kid's perspective, the choice is between receiving one marshmallow now or two marshmallows in a few minutes.

It seems like such a simple equation. Wait a few minutes, and get an extra fluffy, sweet, delicious marshmallow. But you wouldn't believe the excruciating pain those few minutes caused some of the pre-schoolers. Some of them didn't even want to test themselves, and they ate the marshmallow immediately after the researcher left the room. Others developed coping tactics, such as covering their eyes, or turning their chair in the opposite direction, so they wouldn't have to even look at the temptation.

But the interesting thing about the experiment is what it revealed many years later. Mischel kept track of his pre-school test subjects as they developed over the ensuing decades, and he found a striking correlation between being able to wait for that second marshmallow and high performance on behavioral, academic, and professional criteria. In other words, the children who were best able to delay their gratification were the ones who turned out to be the highest achievers.

The lesson for us here is based on the fact that investing is nothing if not actively delaying gratification. To quote Warren Buffett again, investing is "the process of laying out money now in the expectation of receiving more money in the future."

Don't Stress

Our second recommendation is to relax. In another scientific experiment, researchers looked at two groups of Americans: those who graduated from high school, and those who dropped out of high school but then passed the GED (General Educational Development), or high school equivalency, exam.

In theory, if the GED was really an equivalent measure of the education received from high school, the future performance of the two groups should not be noticeably different. But it was. The GED group had a much lower rate of completion for a variety of endeavors: college, military service, marriage.

The researchers reached the conclusion that the reason for the discrepancy was not due to the usual culprits of differences in raw intelligence or parental wealth disparity, but simply to stress.

People under severe stress produce more adrenalin (our body's short-term stress hormone) and cortisol (more of a long-term stress hormone). Imagine how you would react to encountering a bear in the wild. Those hormones that kick in will dilate your pupils, increase your heart rate, and sort of shut down the portion of the brain which handles cognitive thought. For those of us exposed to a "bear" every great once in a while, our bodies are able to come down off the stress high and return to normal. But for people who encounter tremendously stressful situations day after day, the cognitive thinking portion of the brain has less opportunity to thrive.

Conclusion

So if you fear you may be too smart for your own good, and that your intelligence may actually be hurting your portfolio, you can hire a professional to do the investing for you. Or, if you insist on going it alone, relax. Take a deep breath. And try not to get caught up in the hype or hysteria that your fellow investors will invariably display.

Finally, there is one other quote we would like to share, this one from a slightly different source than Isaac Newton or Warren Buffett. As the rapper Ice Cube so eloquently put it, "Check yourself before you wreck yourself."

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