

Bernstein, Jake - The Investor's Quotient*Wiley Publications, 2nd ed 1993, [Behavioural Finance]* Grade

The Investor's Quotient, its first edition (1980) written long before the days of Daniel Kahneman winning the Nobel Prize, is at its core about how to master yourself as a means to the endgame of mastering the market. This classic read was way ahead of its time and ages well due to Jake Bernstein's background as a clinical psychologist and trader.

There are only a few aspects of the book that deem critique: Too often the book strays into the realms of modern-day, glossy "help-thyself" magazines, with tables such as "Positive Things After A Profitable Trade", with advice #5: "Buy something! Now is the time to get that new car or tape player". This tendency, as well as the somewhat lengthy historical sweep of modern psychology brings the overall grade down a notch. However, most books are written with an actual target audience in mind and the book aimed at the budding masses of private investors that slowly started trading again after the horrific decades in the 1960's and 1970's. Nowadays, that target audience has dwindled as the savings pool has shifted into the hands of institutions. But the core message is no less relevant: Past behaviour is a certain indicator of future behaviour.

So, how do you gain a successful investing/trading behaviour? Well, Bernstein says there are basically two ways: either through being extremely fortunate or by sheer discipline. But discipline is more than just a set of rules and it makes no sense if you are following a rule that is not consistent with investment success. Instead, discipline means self-control, consistency, organization, persistence and ability to take action – all attributes that will hike the odds of profitable trading. The overarching objective of the book is, again, to master yourself by a) knowing yourself well enough to know what works best in your hands and b) putting discipline into the very DNA of your market activity.

Market participants of today would surely look back at the line "derived from personal experience in trading the most volatile and demanding markets in history" (referring to the 80's), with a slight "if-only-he'd-known"-smirk. But that is the very thing about investing: Today's future is always the hardest future of them all. Hence, the book's most important part might be the trading-implications from B.F. Skinner's "learning theory". Say you invest in stocks based on two rules: ROE must be more than 15% and PBV must be below 1. One day Stock A meets your criteria, but then you happen to talk to your neighbour who says: "I heard bad things about the CEO, I'd stay away". You take his advice and skip the trade, the stock goes down and you feel good about the whole thing. But this avoidance of a loss will without any shred of doubt lead to "faulty behaviour" and you will be in trouble in the long run.

Because of peoples' constant thirst for (positive) reinforcement, a "faulty" trade resulting in a lucky profit is much more likely to be remembered and acted upon again, as opposed to a "correct" decision leading to a loss. James Montier many years later coined the "process over performance" thinking. Faulty learning then leads to more faulty learning until the road to success is permanently obscured.

This is all fine but in today's harsh reality of daily NAVs, tracking errors, nervous clients and trigger-happy bosses, how can you possibly abide by this? Isn't behavioural finance such a powerful force in modern portfolio management just because so many are trapped within "the institutional barriers"? Certainly, but remember that they are all excuses, not reasons for not investing in a manner where the odds are in your favour. Ultimately, the only person who decides whether you ought to follow your inner convictions and beliefs all the way is you.

Henrik Andersson, January 11, 2012