CONTENTS

Acknowledgments xvii
Introduction 1

PART 1: Investment Philosophy

Introduction 7

1 Be the House:
Process and Outcome in Investing 9
Hit Me 9
From Treasury to Treasure 11
Prioritizing Process 14

2 Investing—Profession or Business?
Thoughts on Beating the Market Index 15
The Scouting Report 15
Evaluating the Winners 17
The Investment Profession Versus the Investment Business 19

3 The Babe Ruth Effect:
Frequency Versus Magnitude in Expected Value 23
Batting with the Babe 23
The Downside of Hardwiring 24
Bulls, Bears, and Odds 25
From OTC to OTB 26
A Useful Analogy 27

4 Sound Theory for the Attribute Weary:
The Importance of Circumstance-Based Categorization 29
Circumstance Over Attributes 29
The Three Steps of Theory Building 30
When, Not What 33
## CONTENTS

5 **Risky Business:**  
Risk, Uncertainty, and Prediction in Investing 35  
Rocket Science 35  
From Uncertainty to Probability 36  
How Predictions Change Future Payoffs 39

6 **Are You an Expert? Experts and Markets** 40  
Man Versus Machine 40  
Where Do Experts Do Well? 41

7 **The Hot Hand in Investing:**  
What Streaks Tell Us About Perception, Probability, and Skill 46  
Finding the Hot Shot 46  
Streaks and Skill 47  
Toss Out the Coin Toss 48  
Streaks and Luck 50

8 **Time Is on My Side:**  
Myopic Loss Aversion and Portfolio Turnover 52  
One or One Hundred 52  
Explaining the Equity-Risk Premium 53  
The Value of Inactivity 55  
Pictures Worth a Thousand Words 59

9 **The Low Down on the Top Brass:**  
Management Evaluation and the Investment Process 60  
Management Counts 60  
Leadership 61  
Incentives 63  
Capital Allocation 64  
The Bottom Line 66

### PART 2: Psychology of Investing

*Introduction* 69

Downloaded from cupola.columbia.edu
10 Good Morning, Let the Stress Begin:
Linking Stress to Suboptimal Portfolio Management 71
Why Zebras Don’t Get Ulcers 71
Why Money Managers Do Get Ulcers 72
Shortening Horizons 73
Imitating Ulysses 76

11 All I Really Need to Know I Learned at a Tupperware Party:
What Tupperware Parties Teach You About Investing and Life 77
A Tip from Shining Shoes 77
You Can Fool Mother Nature 78
All I Really Need to Know . . . 80
The Psychology of Investing 81

12 All Systems Go:
Emotion and Intuition in Decision Making 83
Emotions and Decisions 84
Two Follows One 84
The Affect Heuristic 86
When the Experiential Fails 88
Affect: Individual Versus the Collective 88

13 Guppy Love:
The Role of Imitation in Markets 89
Guppy See, Guppy Do 89
Feedback—Negative and Positive 90
Follow the Ant in Front of You 90
Herding from the Grapevine 93

14 Beware of Behavioral Finance:
Misuse of Behavioral Finance Can Lead to Bad Thinking 94
Sorry Syllogism 94
Mug’s Game? 96
Bombs Away 97
Money See, Money Do 97

Downloaded from cupola.columbia.edu
CONTENTS

15  Raising Keynes:
    Long-Term Expectations, the El Farol Bar, and Kidding Yourself  99

    What Do You Expect?  99
    Speculation and Enterprise  100
    Visiting El Farol  101
    Kidding Yourself  102

16  Right from the Gut:
    Investing with Naturalistic Decision Making  104

    Guns and Better (Decisions)  104
    Chopping Down the Decision Tree  105
    Investing au Naturel  107
    The Fine Print  109

17  Weighted Watcher:
    What Did You Learn from the Last Survey?  110

    I Do—Do You?  110
    Sifting Weights  111
    Misleading by Sample  113
    Tell Me Something the Market Doesn’t Know  114

PART 3: Innovation and Competitive Strategy

18  The Wright Stuff:
    Why Innovation Is Inevitable  121

    Take Off with Recombination  121
    How Does Wealth Happen?  123
    Sic Itur ad Astra (This Is the Way to the Stars)  126
    Creative Destruction—Here to Stay  129

19  Pruned for Performance:
    What Brain Development Teaches Us About Innovation  130

    Too Clever by Half  130
    The Dynamics of Innovation  131
    Investors: Use the Brain  134
CONTENTS

20  Staying Ahead of the Curve:
    Linking Creative Destruction and Expectations  137
    Losing Pride  137
    Goldilocks Expectations: Too Cold, Too Hot, Just Right  138
    Out with the Old, In with the New  139
    The Mind Makes a Promise That the Body Can’t Fill  141
    Expectations and Innovation  142

21  Is There a Fly in Your Portfolio? What an Accelerating
    Rate of Industry Change Means for Investors  143
    Fruit Flies and Futility  143
    Speed Trap?  144
    Investor Evolution  147

22  All the Right Moves:
    How to Balance the Long Term with the Short Term  148
    Managing for the Long Term  148
    Deep Blue’s Lessons  149
    Strategies for Winners  149
    Strategy as Simple Rules  151

23  Survival of the Fittest:
    Fitness Landscapes and Competitive Advantage  153
    A Peek at Another Peak  153
    Fitness Landscapes  154
    Look Before You Leap?  156
    Tools of the Trade-Off  157

24  You’ll Meet a Bad Fate If You Extrapolate:
    The Folly of Using Average P/Es  159
    Social Versus Security  159
    Nonstationarity and Historical P/Es  160
    Why the Past May Not Be Prologue  161
    Bounded Parameters  163
    Unpacking the (Mental) Baggage  164
25  I've Fallen and I Can't Get Up:
    Mean Reversion and Turnarounds  165
    Returns and Growth  165
    Death, Taxes, and Reversion to the Mean  166
    I've Fallen and I Can't Get Up  168

26  Trench Cooperation:
    Considering Cooperation and Competition Through Game Theory  171
    The War Metaphor—Death or Life?  171
    Why a Date and a Marriage Are So Different  172
    Price and Quantity  174

27  Great (Growth) Expectations:
    On the Limits of Corporate Growth  176
    Compounding and Confounding  176
    Reality Check  177
    The Bigger They Are, the Slower They Grow (or Don't Grow)  180
    Refuse Refuge in Castles in the Air  181

PART 4: Science and Complexity Theory

    Introduction  185

28  Diversify Your Mind:
    Thoughts on Organizing for Investing Success  187
    Ant Brain  187
    A-Mazing  188
    Getting a Diversity Degree  190
    Creativity and Investing  191

29  From Honey to Money:
    The Wisdom and Whims of the Collective  193
    Smart Ant  193
    Traveling Salesman? Follow the Ant . . .  194
    Delphic Decision Markets  195
The Stock Market—the Ultimate Hive? 196
Swarm Smarts 197

30 Vox Populi:
Using the Collective to Find, Solve, and Predict 198
The Accuracy of Crowds 198
Needle in a Haystack 199
Weighing the Ox with the Vox 200
Estimating Printers with Populi 201
And Now, For the Real World 202

31 A Tail of Two Worlds:
Fat Tails and Investing 203
Experience Versus Exposure 204
Tell Tail 205
What Fat Tails Mean for Investors 207

32 Integrating the Outliers:
Two Lessons from the St. Petersburg Paradox 209
Bernoulli’s Challenge 209
What’s Normal? 210
St. Petersburg and Growth Stock Investing 214
Integrating the Outliers 215

33 The Janitor’s Dream:
Why Listening to Individuals Can Be Hazardous to Your Wealth 216
Beyond Newton 216
Sorting Systems 217
The Stock Market as a Complex Adaptive System 219
Using What You’ve Got 220

34 Chasing Laplace’s Demon:
The Role of Cause and Effect in Markets 221
Evolution Made Me Do It 221
Laplace’s Demon 223
CONTENTS

Interpreting the Market 224
Investor Risks 226

35 More Power to You:
Power Laws and What They Mean for Investors 229

Zipf It 229
The More Things Change . . . 230
Catch the Power 233

36 The Pyramid of Numbers:
Firm Size, Growth Rates, and Valuation 235

Why Big Fierce Animals Are Rare 235
Find Your Niche 237
Dear CEO: We’ve Made It to the Fortune 50! You’re Fired 237
Extrapolative Expectations 240

37 Turn Tale:
Exploring the Market’s Mood Swings 243

Hush Puppies and Dogs of the Dow 243
Ah Choo 244
Economists, Meet Mr. Market 246
No Progress in Human Nature 247
Maintain Perspective 248

38 Stairway to Shareholder Heaven:
Exploring Self-Affinity in Return on Investment 249

I Could Do That 249
Stairway to Shareholder Heaven 250
Making the Art Less Abstract 251
Order and Disorder 254

Conclusion:
The Future of Consilience in Investing 255

Notes 259
References and Further Reading 291
Index 315

Downloaded from cupola.columbia.edu