Do You Think We Should Tell Them?

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They were so busy looking for what they expected that they totally missed the obvious. It was 1968 and the world had just changed for distance runners. Adidas introduced the first modern running shoe, the Achill, which had a plastic cup in the heel to protect the Achilles tendon. Up until that time, running shoes were crap and many cross country runners struggled with strained Achilles tendons. That made the Achill a must have shoe. Unfortunately, it was too expensive for us poor college students. So, I volunteered to make a run down to Tijuana where the shoes were a lot cheaper if the duty upon reentering the US could be avoided. That condition seemed in jeopardy when, after declaring that I had nothing to declare, I was asked to pull over into the inspection area. Once the border guards opened the trunk and saw the dozen or so boxes of shoes, I knew we were done for. But to my surprise, they started going through each box one by one. I finally realized that because my buddy and I had shoulder length hair, they were looking for drugs, not shoes. As they were finishing up their search I leaned over to my accomplice and whispered, “Do you think we should tell them we’re smuggling shoes?”

The border guards missed the obvious because they were focused on stereotypes, what neuroscientists call representativeness (i.e., long hair is a predictor of drug smugglers). In *Thinking Fast and Slow*, Daniel Kahneman says if there is some truth to the stereotypes then the predictions based on them “may be accurate…[but if] the stereotypes are false… the representativeness heuristic (mental shortcut) will mislead, especially if it causes people to neglect base-rate information that points in another direction.”

For investors, one of the most common stereotypes is that past performance is a predictor of future performance. This erroneous assumption is the result of a subconscious mental shortcut in which the brain substitutes the difficult question, “Is the investment manager skilled?” with one easier to answer: “Is the past performance good?” In an academic paper on mutual fund investor behavior, Brad Barber, Terrance Odean, and Lu Zheng observed, “A fund’s recent performance is viewed as overly representative of a fund manager’s skill and, thus, of the fund’s future prospects…” They go on to say that this false representativeness heuristic causes investors to “… underestimate the tendency of fund performance to mean revert and thus anticipate better relative performance than is realized.”

Mean reversion is the statistical inevitability that a superior performing mutual fund will fall back to the average. It’s no different than flipping coins. You may have a string of heads but in the long run the number of heads will eventually approach 50%. A classic example of mean reversion is Bill Miller, the fund manager for Legg Mason Value Trust. He had one of the most impressive performances ever when his fund beat the S&P 500 Index for 15 years in a row. But Leonard Mlodinow, points out in *The Drunkard’s Walk,* that “…no one would credit a coin tosser… for his lopsided success… [but] many people did credit Bill Miller.” Regrettably, for the many people who did and who put their money where their representativeness heuristic was, Miller’s performance reverted back to the mean. His great years were followed by a string of horrible ones and his lifetime average fell below the S&P 500 Index average.

In the 50’s Dragnet TV series, Joe Friday’s famous line was: “Just the facts, ma'am.” In 1968, a couple of border guards ignored the facts and relied on a negative stereotype instead. While the 60’s stereotype about long hair and drugs probably held some validity, the widely held belief that past investment performance is a predictor of skill has no basis in fact. But that hasn’t stopped investors from mistaking random chance for skill. Mlodinow, says, “…that among a large group of [fund managers] it would be very odd if [by chance] one of them didn’t experience a long streak of successes.” And when that happens the fortunate managers won’t ask, “Do you think we should tell them it’s just luck?”

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