

The FORTRESS PARTNERS

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Bob Ollech
Date: March 19, 2007
Subject: What You Don't Know Can Hurt You

"You know less than you think you do."

James Montier
Behavioral Economist

"As we know, there are known knowns. There are things we know we know. We also know there are known unknowns. That is to say we know there are some things we do not know. But there are also unknown unknowns, the ones we don't know we don't know. "

Donald Rumsfeld
Former US Secretary of Defense

There is a widespread and well-documented phenomenon familiar to psychologists termed "flawed self-assessment" the crux of which is that people systematically overestimate their competence, their relevance, and their future actions. With few exceptions, we think we are smarter, better looking and more important than we really are. Like the residents of Garrison Keillor's fictional Lake Wobegon, we all tend to think our children are above average and that we are good looking. (The research also shows that men are more extreme in their high opinions of themselves than are women--sorry guys.)

As a result of our inflated self-views, we tend to take credit when good things happen to us and lay the blame for our failures on others. That's not all bad; that mindset can buffer people from stress and depression and motivate them to press on with difficult tasks. On the whole, however, errors in perception are often to blame for many of our woes. The most incompetent among us are twice handicapped because they are not only lacking in skill, but are also unable to recognize their own deficiencies. They are victims of Rummy's "unknown unknowns." This group seems to suffer disproportionately because they consistently over-estimate their contributions at work and at home. They are less likely to listen to valid, but negative, criticism from their boss or their spouse and are less likely to question their own impulses. These folks tend to get fired and divorced more often and are the ones who buy a stock based on a tip from their barber, or make a large investment without thoroughly researching it because "they know the business." They are the ones who too often "buy high and sell low."

Over-confidence in our abilities and our unwillingness to recognize, much less admit, that chance (or luck) is frequently responsible for our successes can lead to a pattern of bad decisions over time, which may ultimately hurt us, socially, physically and financially.

In his book, *Fooled by Randomness*, Nassim Taleb, a derivatives trader for nearly 20 years, lays out one example after another of events that individuals thought they were responsible for when, in fact, the outcome was entirely due to chance. Most of us attribute our successes to some other factor, usually a very precise reason that we controlled. "Luck, you say? My success was the result of hard work and skill – luck had nothing to do with it!" That view is widespread in the investment business, where egos can be exceedingly large. During the run up to the tech bubble a former colleague of mine managed a mutual fund based on a technology stock index. For several years, as investors flooded into tech stocks, the fund earned outsized returns, including one year when it topped 100%. Each day, at the market open, my co-worker invested the prior

day's inflows into a basket of stocks that mimicked the index, a mechanical process that required no knowledge of the underlying stocks. Still, it wasn't too long before he came to believe that he was a tech stock guru. Who could blame him? The fund was booking big returns and investors were sending in their money. Reporters from the financial press called for his views on everything from microchips to nanotechnology. A sketch of his face accompanied a story about the fund in the Wall Street Journal. Did he develop the index upon which the fund was based? Nope. Was he carefully selected from a group of expert tech fund managers? Nope. He happened to be running another of the firm's index funds and had the time to run yet another one. Was he responsible for the sky-high returns of "his" fund? No more than he was responsible for its subsequent 75% decline when the tech bubble burst. Still, he was confident that he understood technology stocks so well that he over-weighted them in some of the firm's managed accounts and stuck with those positions even as they plunged in value. Today, he has a different employer and "his" fund is managed just as capably by another person. The investment world is littered with similar stories.

What does this all have to do with investing today? Simply this, recognize that people who invest money--their own or others'--are still human beings that suffer from the same biases and tendencies as the rest of the population. When they learn about the concept of flawed self-assessment, a surprising number of them still think "now that I understand the biases of others, I can use that to outthink them because I am smarter than they are." By now readers who are still with me are rightly thinking that isn't the best answer. Better is a reflection along the lines of "Hmmm, I know I have biases. If I can understand them and figure out a way to spot them when they are most likely to appear, maybe I can minimize them and make better investment decisions." Philosopher Karl Popper wrote that after setting up a hypothesis, you should test it to destruction, looking for all the evidence that goes against your view. That doesn't happen often on Wall Street where if someone takes a view on a stock or a market, he wants to hear all the evidence that supports that view. Most people are not inclined to sit down with people who disagree with them, despite the fact that doing so will often help them to make better decisions.

Many of the world's best investors focus their efforts on specific segments or sectors of the market, realizing how difficult it really is to consistently outperform in an environment where the only constant is change. They tend to stick to their "known knowns," but try to be aware of the things that they don't know. They are data processing junkies, able to aggregate reams of information and assimilate widely divergent views, even those that are out of synch with their own. They are also masters at filtering out the noise that surrounds the critical information necessary to make consistently sound decisions. And many of them are avid students of human nature, including themselves. Accordingly, they recognize and control their own biases, which helps them to recognize opportunities and risks that others may not see. Are they ever wrong? Frequently; but they're wrong less than the average investor and that is what sets them apart.

Bottom line? Most of us suffer, at least to a degree, from thinking that we know more than we do. Biases are an ingrained part of the human condition and the vast majority of people don't even recognize they have them. If you can recognize and control your biases, you will end up making consistently better investment decisions and will end up richer for it. As a special dividend, that process may well carry over and help you make better decisions in other areas of life.

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CAPITAL MANAGEMENT, LTD.

700 Walnut Ridge Drive, Ste 200, Hartland, WI 53029
262-369-5369 (Jon Bruss) • 262-369-5742 (Bob Ollech)