

The investor's chief problem and even his worst enemy is likely to be himself.

... Benjamin Graham

There's an old saw about two young fish swimming along, and they happen to meet an older fish swimming the other way, who nods at them and says, "Morning, boys, how's the water?" And the two young fish swim on for a bit, and then eventually one of them looks over at the other and goes, "What the hell is water?"

The immediate point of the fish story is that the most obvious, pervasive, important realities are often the ones that are the hardest to see and talk about. Of course, this may just sound like hyperbole. But when we look back with 100% clarity on past history, events that transpired seem so clear we wonder how the signals could possibly have been missed. In fact, a huge percentage of the stuff we tend to be automatically certain of is, through the fullness of time, wrong and deluded. That failing is referred to as "bias blindness".

Over the years, we've written that, to be successful in the long term, an investment professional has to clearly understand finance, accounting, and economics. The delineation between luck and prosperity, in portfolio terms, comes from experience – and a healthy dose of cynicism. But beyond the learned skills necessary for success, one also needs an understanding of psychology.

Consider this: we rarely reward those who show caution and humility in the face of uncertainty, as demonstrated so vividly in the current US presidential race. Investment professionals, both by design and by culture, are anything but humble in their approach to investing. Yet, to this writer's thinking, the best decision-makers are all curious, humble, and self-critical, give weight to multiple perspectives and feel free to change their minds often.

If one steps back away from media sensationalism for a moment, one might describe market direction as a proxy for investor perception of the current economic environment. Ben Graham was quoted as saying the market's a weighing machine in the long run, but in the

short-term it's a voting machine. Tying the two together, perhaps market direction is best described as the collective opinion of those who participate in it; again to paraphrase Graham, a "barometer of investor sentiment".

But does the market really "know" anything? If a market is really just a compilation of investor sentiment, often exaggerated by fear and greed, then doing the same thing as everyone else exposes you to fluctuations that are, in part, exaggerated by their actions as well as your own. Many brilliant investors – Graham, Buffett, Marks, Templeton to name but a few – tell us the only way to better long term results is to be a contrarian to the trend.

Accepting the premise of being a contrarian is one thing, putting it into practice quite another. If one believes market sentiment acts like a pendulum – a favourite metaphor of Howard Marks – one would also have to acknowledge that the over-arching bias tends to be fear. It's the human condition to constantly worry. To quote Marks, "the market does not have above average insight, but it often is above average in emotionality".

Which is why an understanding of psychology is so necessary. Because market direction is largely based on sentiment, there is an underlying cyclicity in mood which can be governed by exogenous events that have no bearing on the value of the underlying investments. Some of the greatest investment opportunities are presented by understanding the cyclicity of investor sentiment.

In short, if market prices reflect the average opinion, then following the conventional wisdom will not generate above-average performance.

In our increasingly data-soaked and algorithm-dominated world, our tastes and preferences are increasingly known, catered to and carefully influenced. If we have learned how to think and to pay attention, we can know that we have other options entailing less risk and considerably more long-term reward. Knowing better what the hell we're splashing around in will make us more aware of those opportunities.