Do you know the names of the stocks you own? That may seem like a funny question, but simply knowing the names of your holdings puts you at risk of making behaviorally driven decisions, such as acting on emotionally fueled news stories, according to C. Thomas Howard, author of the book *Behavioral Portfolio Management* and CEO and director of research at Athena Investment Services. His “no-name portfolio strategy” has guided his Athena Pure Valuation | Profitability portfolio to a 25% annual return over the past 12 years, including a 67% jump in 2013. Howard, who spoke at the 2014 CFA Institute Annual Conference, is also professor emeritus at the University of Denver’s Reiman School of Finance. In an interview with *CFA Institute Magazine*, he explained why behavioral portfolio management is “the next paradigm” for investment management, the argument for limiting investment process decision making to a few strict criteria, and the importance of “ruthlessly driving emotion out of your decision process.”

**What inspired you to write *Behavioral Portfolio Management***?
Behavioral finance is the next paradigm. We are moving away from modern portfolio theory. I think it’s a new way to look at the world. We all hear about cognitive errors. Look at the success of Daniel Kahneman’s *Thinking, Fast and Slow*. How do we work with clients to help them avoid these cognitive errors?

We recognize that virtually every investor makes emotional decisions. There have got to be price distortions. In fact, they’re all over the place. How do you harness those price distortions and build successful portfolios? That was the motivation for the book. This represents 30 years of my research and the research of others, and it really gathered steam when the finance literature, which is empirical literature, turned decidedly against modern portfolio theory.

**What’s different about behavioral portfolio management**?
Most active equity managers say things like, “We go visit lots of companies. We understand their management. We understand their products, markets, and competitors. We do all the fundamental analysis.” Others say, “We try to value the company, look at the cash flows, look through the financials very carefully. Or we keep track of events, like mergers and takeovers and spin-offs, and that’s how we make money.”

The truth is, they’re uncovering behavioral price distortions. They just do it in different
ways. We go out directly and say, “We’re just trying to identify measurable and persistent behavioral price distortions.” Ultimately, I think all managers would admit that’s the game we’re all playing. We just go at it very differently. When the dust settles a few years from now, everybody’s going to say, “Well, yeah, we were doing behavioral stuff all the time. We just didn’t call it that.”

**You define two groups: emotional crowds and behavioral-data investors.**

Emotional crowds dominate the markets. Anybody who’s spent any time in the stock market knows the markets are irrational. There is absolutely no sign of rationality whatsoever.

In the formal language of finance theory and finance academia, we speak of “return factors.” What are the return factors that drive returns? We know those return factors are the result of some collection of investors making buying and selling decisions. I refer to that collection as “emotional crowds” because they are largely driven by emotion.

Robert Shiller, who won the Nobel Prize in 2013, contended 30 years ago that there’s very little sign of fundamentals in stock returns. He’s done a lot of research since then, and that piece still stands today. Emotional crowds drive the markets.

Behavioral-data investors try to pull themselves away from that emotional price-setting process. We try to identify the resulting distortions and build portfolios on that.

**Is emotion really that dominant in the markets?**

We’re all emotional. We all make emotional decisions. In fact, most people take great pride in that. You’ve heard people say, “I depend on my gut.” But when it comes to investing, it’s damaging. People just go into investing and use the same decision process they use in everything else. That turns out to be a very poor way to make investments.

One example is that investors are constantly bombarded with information. When you’re watching CNBC or one of the other channels, they’re constantly spilling out information. We tend to grab onto those pieces of information disproportionally. We react to those.

Related to that is the availability bias. Whatever’s available to us right now, we make our decision based on that. A variation of that is the availability cascade, which we see all the time in the news. We begin to talk about something, and everywhere you turn, you see it. It begins to dominate our thinking. In the case of financial markets, people talk about the Federal Reserve. If you hear it all the time, it begins to dominate your thinking.

**What’s your investment process?**

We said to ourselves, “Let’s manage portfolios recognizing that we all, left to our own devices, will make these kinds of emotional decisions.” I call it ruthlessly driving emotion out of your decision process. As ruthlessly as I can, I drive everything out of the decision process that is emotionally driven and has nothing to do with my investment process. That’s what we do in terms of managing money.

**What does that mean in practice?**

It means we don’t pay attention to anything—literally. We have five criteria in the “Pure” portfolio. That’s all I pay attention to. Whatever’s happening that day in the news—ignore it completely.

**What are the five criteria?**

One is dividends; we buy stocks that pay dividends. Companies that pay dividends are saying to the market, “We believe we have earnings into the foreseeable future.” It’s a powerful signal. It’s putting your money where your mouth is. In identifying behavioral price distortions, I look for situations where people are putting their money where their mouth is.

Analyst earnings estimates are the second factor. Based on the forward P/E, analysts are saying there’s enough future earnings to justify the current price. Now I have two opinions on the company—management’s opinion and the sell-side analyst’s.

Third, I want companies with as much debt as possible. If I find one with a negative net worth, I’m thrilled. Now, when most people hear that, their lip curls and they say, “That’s bad.” The reason debt is attractive is because the underwriter or the bank worked closely with the company and decided they could make the loan and the firm would repay it. I’ve now got a commitment from three sides—again, people putting their money where their mouth is, saying, “Yes, we believe in this company.” The greater the debt, the better I like it.

Then, I use a price-to-sales ratio. Sales are the least manipulated of accounting measures and have been shown to be one of the best predictors. And I have a minimum sales threshold. Those are my five criteria.

**Aren’t these basic balance sheet metrics rather than distortions?**

They are distortions. Investors tend to underreact to dividends; they don’t realize how powerful a signal it is. The typical response to dividends is a downgrade of growth prospects. It turns out it’s just the absolute opposite of that—the higher the dividend, the higher the return, the higher the growth of the company.

Investors also tend to overreact to debt. If a company has lots of debt, they tend to run away from it. I’m harnessing these particular behavioral mistakes.
What names do you hold in your portfolio?
I don't know the names of the stocks I own.

Really? Are you serious?
I'm serious.

How does that work on an operational basis?
I have to know them long enough to tell our traders to trade them, but beyond that, I don't remember the names. The reason is a component of my process. I ruthlessly drive emotion out of my decision process. I make no attempt to remember names any longer than it takes for me to say, “Trade this stock.” I just don't remember. Now, I do look at them from time to time. They'll float through my brain, but it's nothing that I keep track of.

Why should I remember the name of a stock? It's not part of my process. I believe the name of a stock creates emotional problems. You could wipe out the name and call this stock “123.”

Are you saying you don't place importance on names, or are you actually saying you don't remember the names?
I literally don't know the name. I cannot name the 10 stocks that I currently own.

How do you decide to sell?
I look at my five criteria on a monthly basis. When they fail at one of those five criteria, I sell them. On my screens, the name is on the far left. I look over and say, “OK. I want to sell that stock.” I send it to the traders, and it’s gone. I don't remember the price that I paid for the stock either. I really don't know whether my stocks made or lost money. I follow the portfolio—I know it's going up—but I have no idea which individual stocks are going to make money or lose money.

Again, I'm ruthlessly driving emotion out of my decision process. When I started managing a portfolio, this is exactly what I was trying to do. I've done research for years on huge databases and studied different anomalies and how you build portfolios. Not once was the name of the stock important to those studies. This is taking the context of behavioral portfolio management to the extreme.

What’s your turnover like?
We hold stocks one to two years in this portfolio. Once I sell it, I never look at it again, but that's pretty easy because I don't remember it in the first place. Don't waste your time on regret.

The other thing I do to drive the emotions out of the decision process is I never make an investment mistake. I know that sounds arrogant, but at the time I made the decision, that was the best decision I could make. Based on the information, that was a good stock. But in fact, only 60% of my stocks beat their benchmark. The other 40% are not mistakes; they just did not work out. But there was no way to know that at the time I made the initial investment decision.

You don't read news about the company?
Absolutely not. Well, I don't remember the name of the stock, so if a story did come up, I wouldn't know about it anyway.

What about at the time you decide to invest?
Do you read up on the company?
No, I don't generally know what my companies do.

You don't look into their operations?
No. Five things—that's all I look at. The only things you want to put into your investment process are things that help you make better decisions. I don't want to do anything that helps me feel better. I couldn't care less if I feel better about my portfolio. If there's data or something I've uncovered that I know is measurable and persistent, I will include it. Otherwise, I ignore everything else.

How did the Pure portfolio come about?
Pure came from my years of teaching and doing research. I took my knowledge and built a portfolio around it. Pure is a proof of concept of behavioral portfolio management. When you push behavioral concepts to the extreme, what happens? This portfolio has generated 25% a year for 12 years. Last year, it generated 67%. It was the number one portfolio in its category in the United States in 2013.

As an academic, I spoke about these ideas for years, and people would say, “Ah, Tom, you're just an academic. You have no proof of this because you haven't done it.” Now here I am successfully managing portfolios, so I'm hoping people will cut me a little slack.

You've said many industry best practices are actually "emotional catering."
We talk about the markets as the cult of emotion, which means essentially [that] all prices are driven by emotion. Very few fundamentals are reflected in prices. Around that cult of emotion is built an industry that we call the “cult enforcers.” Even if I (as an investor) decide to get out of the cult of emotion, I've then got to go up against almost all of the industry practices to do that because the industry has been built around enforcing that cult.

A classic from a legal standpoint is the Prudent Man Rule. That's a legalizing of the cult of emotion. What's a prudent man? The “prudent man” is the typical emotional investor.

Modern portfolio theory is part of the problem and not part of the solution, because modern portfolio theory is built around volatility. Volatility is largely emotion. In the short term, obviously, volatility is risk. If I need money in three months, I do have to worry about that. But if I'm building long-horizon wealth, volatility is largely emotion. If I build a portfolio based on volatility, which is, of course, Markowitz's mean–variance optimization, that's really short-term emotion optimization. It's institutionalized.

Every investment professional in the industry talks about volatility, drawdown, upside capture, downside capture, the Sharpe ratio (which is a long-term return to short-term emotion), and tracking error. Almost everything they do is based on modern portfolio theory and has emotion built into it and therefore reinforces the cult of emotion.

Even if I decide as an investor that I'm going to de-emotionalize my process, almost every investment professional I talk to will essentially push me back into the cult of emotion.
because, “Well, you need to worry about volatility.” We see this all the time. It’s really, really a challenge to step away from the cult of emotion.

**How does emotional catering factor with clients?**
Investors create volatility by reacting emotionally to events. When volatility gets high, they get more emotional. The other problem is myopic loss aversion. If you have a manager that lets a client down for a quarter or a year, they may move their money elsewhere. So a client’s emotion has been turned into a business risk for the asset manager.

**EVEN IF I (AS AN INVESTOR) DECIDE TO GET OUT OF THE CULT OF EMOTION, I’VE THEN GOT TO GO UP AGAINST ALMOST ALL OF THE INDUSTRY PRACTICES TO DO THAT BECAUSE THE INDUSTRY HAS BEEN BUILT AROUND ENFORCING THAT CULT.**

**How do clients participate in the cult of emotion?**
Clients say to investment professionals, “Don’t lose any money.” We ask, “Over what period of time?” “Well, over the next quarter, the next year.” This is myopic loss aversion, the cognitive error that investors make. Short-term volatility gets diversified away over the long run, but people simply don’t see it due to their short time frame for making decisions.

In the industry, when people talk about risk, they really mean three things. Number one, there’s probably a fair amount of emotional volatility associated with this investment. Number two, that [emotional volatility] gets translated into business risk for me as a financial professional, because you might take your money and go elsewhere. Number three, there’s some investment risk, but we don’t really know how to measure that. The word “risk” is really primarily emotion. When asset managers say “risk,” it’s actually business risk for them, not investment risk for the client.

**You don’t believe in diversification either, correct?**
There are two situations where diversification makes sense. One, you don’t want to buy one stock or two stocks. You want a reasonable number. I think somewhere around 10; at the most, 20.

The other place where diversification makes sense is when you’re putting asset classes together. If the two asset classes have about the same expected return, then it does make sense to diversify, because now you’ve reduced your volatility, which means you’ve increased long-term effective return. If the asset classes have widely different expected returns, then diversification makes absolutely no sense.

The primary driver of long-horizon wealth is expected returns. Why would you invest in anything but stocks? Why isn’t your portfolio 100% stocks? Do you believe stocks are going to have the highest expected return? By the way, stocks have averaged 10% a year for a long period of time. Bonds have averaged about 6%. The difference between a portfolio that’s 100% stocks and one that is a mixture of stocks and bonds over long periods of time is huge, possibly millions of dollars. Why would I want to buy anything but the highest expected return, asset-wise?

Now, in terms of keeping clients, if I add a few investments that make them more likely to stay in the portfolio when times get rough, then that’s fine. But let’s recognize it for what it is. There are very few wealth-building arguments for diversification. Again, it’s a way of managing the emotions of your clients and keeping them in their seats. We’d much rather have them stay in the portfolio, even if we have to water it down a little bit, than find that they bolt the portfolio when things turn tough.

Managing the emotions of clients is the most important thing a financial adviser does in terms of building long-term wealth—period. It’s not finding the best managers, the most sophisticated managers. It’s keeping clients in their seats.

**How do your clients find you?**
We had two portfolios that were number one on Morningstar last year. One of them was the Pure portfolio, and the other was our Global Tactical ETFs. People are coming out of the woodwork. We now have US$150 million in assets under management. We’re doubling about every year.

We provide our services through advisers, so we’ve developed strong adviser relationships. We have a core of several dozen advisers. We think of ourselves as an intellectual property shop, so we’re not building out a big sales force, wholesalers, and so forth. We’re establishing strategic partnerships—strategic relationships with partners.

**Do your clients realize that you don’t know the names of your investments?**
We don’t deal with direct clients because we deal through advisers. The advisers are our buffer. Advisers provide lots of services, but this one is just absolutely critical. The advisers essentially act as a barrier between me and the client. Our biggest adviser is always kidding me. He knows I don’t remember the names of the stocks I hold, and he says, “I know all the names. I can tell a story about every stock when a client asks a question.”

Clients like stories. For some reason, people want to like the stocks that they own. The only reason to buy a stock is to make money. Stocks are not friends. They’re not family. They’re there to make money. When you don’t think they can make money any longer, you get rid of them.

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