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Invest Like Mr. Spock, Not Homer Simpson

How portfolio manager David Potter puts Richard Thaler's behavioral-economics theories into practice.

By Crystal Kim

Richard Thaler built his career on studying investors' foibles. When he began his pioneering work in behavioral economics in the 1970s, it was shunned by economists and psychologists alike, and "known to be a stupid idea," says Thaler, now 69. Today, though, it is the backbone of some of the most nuanced thinking on investment strategy.

Behavioral economists argue that investors' frequent lapses in judgment combined with a herd mentality can have serious repercussions on the stock market. Meanwhile, understanding and exploiting those mistakes can lead to market-beating results. This idea, of course, directly conflicted with another that had been gaining traction—Eugene Fama's efficient-market hypothesis, which argued that the market was rational and investors couldn't consistently beat the market because all of the information was already built into share prices.

Thaler now teaches behavioral economics under the same roof as Fama, at the University of Chicago's Booth School of Business, and since 1998 has been a principal at Fuller & Thaler, a small investment firm with $3.6 billion in assets under management. His latest book, Misbehaving: The Making of Behavioral Economics, will be published in May.

David Potter, a former student of Thaler's, runs the $2 billion JPMorgan's Undiscovered Managers Behavioral Value fund (ticker: UBVAX)—subadvised by Fuller & Thaler—putting the professor's theories into action. Potter, 43, joined Fuller & Thaler in 2005 after a brief stint as an investment banker in financial institutions at Goldman Sachs. Since Potter came aboard, the small-stock value fund has beaten its benchmark, the Russell 2000 Value Index, by two percentage points and the Standard & Poor's 500 index by one. The fund also beat more than 75% of its peers over one and three years, and more than 95% over five and 10 years.

Barron's spoke with Thaler and Potter about why the average investor is more Homer Simpson than Mr. Spock, and how other investors can use the typical mistakes to their advantage.

***Barron's:* You've studied behavioral economics through the bull market of the 1980s, the technology bubble of the 1990s, and the financial boom and bust of the past decade. What lessons can investors draw from the past 40 years?**

Thaler: What investors should have learned is that prices can get seriously out of whack. The creature we study in economics is similar to Mr. Spock from Star Trek, who was coolly rational, unemotional, and found humans to be odd creatures with peculiar weaknesses. Most psychologists—and I am somewhere between an economist and a psychologist—analyze their own behavior and that of the people they work and live with. The world I study is full of people more like Homer Simpson—a little chubby, with a poor memory; who has trouble with long division, much less determining the present value of a stock.

What are some of investors' common "D'ohs"?

Thaler: We have to start with self-control. Are you saving enough for retirement? That's more important than how you invest. Many people fail to sign up for their 401(k) plans even with a company that offers a match, which is a 50% rate of return on your money instantly. That's a no-brainer.

There was lots of misbehavior during the housing bubble. It's hard to know where to point the blame. Was it the borrowers who took out mortgages they couldn't afford once rates reset, expecting their home values to continue to go up? Was it the lender who gave them that money? Or was it the investor who bought a pool of those mortgages? Or was it the rating agency that said that the portfolio is risk free?

The biggest problem is overconfidence and attempting to invest on a do-it-yourself basis. Professional mutual fund managers on average do not outperform the market, so why should individuals think they can do better than the professionals, who have much better data? The pitfall is thinking you know more than you do.

(over please)

Let's put investors on the couch. What do they need to understand about their own behavior?

Thaler: Investors are really good at mistiming the market. When markets are far above their historical norms, returns tend to be lower—but that's when investor expectations are also at peaks.

After the [recent] crisis, investors reduced their equity holdings by a lot and didn't buy until much later. Net flows into equities did not go positive until 2013. Investors missed the entire run-up from the bottom in 2009. Looking back over a long time period, investors have a perfectly horrible record of picking tops and bottoms.

Potter: Many investors also succumb to the Disposition Effect, which means they're predisposed to selling too early. There are psychological reasons for this, such as mental accounting. Let's say you buy a stock and it goes from $10 to $20. In your mental accounting framework, you classify that $10 as a paper gain.

Daniel Kahneman's and Amos Tversky's Prospect Theory proposes that people become more risk averse when they are in the domain of gains than when they are in the domain of losses. So when you buy something at $10 and it goes up to $20, you are far more likely to sell that stock [to preserve your gain] than if you buy a stock at $10 and it goes down to $5. If it's down to $5, you actually become more risk-seeking; you are willing to hold on in the hope that it will go back to $10.

Can investors use this knowledge to their advantage?

Thaler: Yes, but let me give you an example. You go to a baseball game and a pitcher throws a sinker, which is a ball that dips as it reaches the batter. You can predict the batters will hit a lot of ground balls, because they will swing slightly too high. If we're the defensive team, we're going to bring our fielders in. That's what we're trying to do—predict other peoples' biases. It's easier for me sitting in the stands to say, "He's going to hit a ground ball" than it is for the batter to say, "Damn, that guy is going to keep throwing sinkers, I have to swing a little lower." Easier said than done.

So you can anticipate human error, but you can't do anything about it?

Thaler: Exactly, so we impose a discipline. We never ask our portfolio managers to perform tasks that would make them vulnerable to these same biases, because unfortunately, we are limited to hiring humans. Spock isn't available. We try to develop a discipline where the managers are not as subject to these biases. For example, we don't visit companies, because it's a sure way to get biased.

Potter: We also don't set price targets, going back to the Disposition Effect.

How do you turn the mistakes of others into opportunities?

Thaler: Both small-cap and value stocks are winning strategies over the long run, though there are periods when large-cap stocks outperform small-caps. In terms of the small-value strategy, we can do better by narrowing that list down to ones that we think are influenced by investors' biased expectations.

Potter: The value premium—that low-price-to-book outperforms high-price-to-book—is well known. But in the past 10 years, especially in small-cap stocks, the value premium has disappeared. The Russell 2000 Growth index beat the Russell 2000 Value index by almost three percentage points a year. In the past two years, growth has outperformed value by a whopping seven points a year. That's not sustainable. The value premium should come back.

Dick's "Does the Stock Market Overreact?" paper concluded that portfolios of prior losers subsequently outperformed prior winners. We try to identify companies that have significantly underperformed their peers and the market, and therefore have negative bias permeating the investor base. We're looking for a gradual downward slope [in share price] brought on by consecutive quarters of missed or mediocre earnings reports.

Some of those stocks deserve to be down.

Potter: We look for companies that have seen their valuation multiples compress to degrees that indicate the share price decline is not commensurate with its decline in earnings. So we validate the business model, the valuation at which it trades, and the company's credit quality.

How do you identify specific stocks?

Potter: We look for two signals: significant insider buying and share buybacks. Then we look for negative herd mentality, meaning when positive news comes along, there's a muted response. The understanding is that if there is a negative bias for a particular stock, there will be an underreaction to that positive signal. As a contrarian investor, we accept that for what it is—behavioral—and quickly do our fundamental work.

Of course, it can be painful on the way down. There's a lot of client hand-holding. I'm almost embarrassed to tell them what I'm buying. But like in 2008-09, when massive amounts of securities were mispriced almost exclusively due to behavioral biases, we take advantage. It takes a strong stomach and discipline to stick by your process when others are not willing to do so.

Which stocks has that led you to recently?

Potter: Tidewater [TDW] is the owner and operator of the largest and newest fleet of offshore service vehicles, which bring mud, drills, and piping that deepwater oil and gas rigs need. Its stock declined from the low $50s last year to the low $20s.

The CEO and [other top executives] purchased stock; the chief financial officer spent about 50% of his 2014 cash bonus on the stock. The board also purchased $100 million [in a share repurchase plan] in its last calendar quarter. But we are just long enough into oil prices' decline that the negative bias has permeated the herd. You're not seeing positive reactions when insiders are buying stock. That's really quite typical of a herd mentality; they just don't believe the management team is right. They believe their own negative biases.

That negative bias has taken its valuation to a historical low, half of where it was during the financial crisis. Yet, Tidewater is going to be a consolidator in this downturn, given its financial strength.

Investors Bancorp [ISBC], a New Jersey–based community bank and one of your larger holdings, recently hit an all-time high. You don't have price targets, so when do you sell?

Potter: Investors Bancorp is an example of how we let our winners run. We still think the stock has been extremely undervalued and has robust returns ahead. We bought this stock six years ago, and it has returned four times our initial investment.

In the midst of the financial crisis, the CEO, the chief operating officer, and several directors were buying stock. The bank had strong loan underwriting, and as a result was one of the few banks that did not accept government money under the Troubled Asset Relief Program.

In 2009, when banks were crumbling under the weight of poorly underwritten loans, Investors Bancorp only charged off $15 million on a loan portfolio of $6 billion; that's less than a quarter of 1%. The FDIC estimates that the average was 3%. Last year, the company wrote off only eight basis points—$11 million on a $14 billion portfolio.

Clean Harbors [CLH] doubled its share buyback program. Yet, its stock is down 15% since its all-time high in 2012. What's the story there?

Potter: Clean Harbors lowered guidance in late-February 2014. Its stock had fallen before, but that really exacerbated the decline. We bought the stock in the mid-to-high $40s a year ago, after the company announced a share-repurchase program. Then the CEO went on to buy $1.2 million worth of the company's stock for himself.

The company drives waste from various industries into its vast network of incinerators and landfills. There are high barriers to entry to build these facilities and get regulatory permits. At a 2013 investor conference, the company said no new landfills have been permitted in the U.S. in 18 years, and no new hazardous-waste incinerators have been built in the past 15 years. The company's earnings before interest, taxes, and depreciation margin is 16%, and we think it can go up to 20% in the next five years. That will certainly improve its valuation. We don't want to succumb to the Disposition Effect, so we're going to hold on to this winner for as long as we can.

Thank you, gentlemen.

Undiscovered Managers Behavioral Value Fund

	Total returns		Average annual total returns			
Performance at NAV (%)	**Latest QTR**	**YTD**	**1 yr**	**3 yrs**	**5 yrs**	**10 yrs**
A Shares	3.74	3.74	6.93	16.30	16.24	9.82
Institutional Shares	3.85	3.85	7.35	16.70	16.57	10.09
Russell 2000 Value Index	1.98	1.98	4.43	14.79	12.54	7.53
Lipper Small-Cap Value Funds Index	1.88	1.88	3.07	13.54	12.39	7.93
With sales charges (%)						
A Shares with 5.25% max. sales charge	-1.71	-1.71	1.31	14.23	14.99	9.23

Calendar-year returns (%)	2010	2011	2012	2013	2014
A Shares at NAV	31.72	-1.71	23.28	37.10	5.30
Russell 2000 Value Index	24.50	-5.50	18.05	34.52	4.22
Lipper Small-Cap Value Funds Index	25.74	-4.82	15.56	35.26	3.05

The performance quoted is past performance and is not a guarantee of future results. Mutual funds are subject to certain market risks. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than original cost. Current performance may be higher or lower than the performance data shown. For performance current to the most recent month-end, please call 1-800-480-4111.

The ranking information is provided by Lipper Analytical Services.

The Undiscovered Managers Behavioral Value Fund - A shares at NAV was ranked against the following number of funds in the Small-Cap Value Funds Category for the period ended 3/31/2015. For the 1 year period 81 out of 308 funds. For the 3 year period 60 out of 261 funds. For the 5 year period 7 out of 219 funds. For the 10 year period 10 out of 153 funds. **Past performance is no guarantee of future results. Rankings are calculated based upon the total returns of multiple share classes within their respective Lipper category. Different share classes may have different rankings.**

Annual operating expenses	A Shares	Institutional Shares
Expense cap expiration date	12/31/2015	12/31/2015
Expense cap (%)	1.30	0.90
Total annual Fund operating expenses (%)	2.08	1.62
Fee waivers and/or expense reimbursements (%)	(0.51)	(0.45)
Net expenses (%)	1.57	1.17

The Investment Advisor, Administrator and Distributor (the "Service Providers") have contractually agreed to waive fees and/or reimburse expenses to the extent that Total Annual Operating Expenses (excluding Acquired Fund Fees and Expenses, dividend expenses relating to short sales, interest, taxes, expenses related to litigation and potential litigation, extraordinary expenses and expenses related to the Board of Trustees' deferred compensation plan) exceed the expense cap of the average daily net assets through the expense cap expiration date. This contract continues through that date, at which time the Service Providers will determine whether or not to renew or revise it.

Portfolio statistics	A Shares	Institutional Shares
Inception date	6/4/2004	12/28/1998
Investment minimum	$1,000	$3M
Fund number	1390	1368
CUSIP	904504586	904504842

Top ten holdings (%)

Company name	Sector	Percentage
HCC Insurance Holdings, Inc.	Financials	3.7
Investors Bancorp, Inc.	Financials	3.4
Convergys Corp.	Information Technology	3.3
Piedmont Natural Gas Co., Inc.	Utilities	2.9
Copart, Inc.	Industrials	2.4
ACI Worldwide, Inc.	Information Technology	2.1
Symetra Financial Corp.	Financials	2.1
First Niagara Financial Group, Inc.	Financials	2.0
CNO Financial Group, Inc.	Financials	2.0
Commercial Metals Co.	Materials	1.9
TOTAL		**25.8**

The top 10 holdings listed reflect only the Fund's long-term investments. Short-term investments are excluded. Holdings are subject to change. The holdings listed should not be considered recommendations to purchase or sell a particular security. Each individual security is calculated as a percentage of the aggregate market value of the securities held in the Fund and does not include the use of derivative positions, where applicable.

Contact JPMorgan Distribution Services, Inc. at 1-800-480-4111 for a fund prospectus. You can also visit us at www.jpmorganfunds.com. Investors should carefully consider the investment objectives and risks as well as charges and expenses of the mutual fund before investing. The prospectus contains this and other information about the mutual fund. Read the prospectus carefully before investing.

RISKS ASSOCIATED WITH INVESTING IN THE FUND:

The Fund may invest a portion of its securities in small-cap stocks. Small-capitalization funds typically carry more risk than stock funds investing in well-established "blue-chip" companies since smaller companies generally have a higher risk of failure. Historically, smaller companies' stock has experienced a greater degree of market volatility than the average stock.

RETURNS:

From the commencement of operations of the Fund's Institutional Class until January 30, 2004, the Fund's investment adviser was Undiscovered Managers, LLC. Effective January 31, 2004, J.P. Morgan Investment Management, Inc. (JPMIM) became the Fund's investment advisor. Fuller & Thaler Asset Management, Inc. serves as the Fund's sub-advisor. The Fund is currently waiving fees. Please note the removal of this waiver would reduce returns.

INDEXES DEFINED:

The Russell 2000 Value Index is an unmanaged index, which measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. The performance of the index does not reflect the deduction of expenses associated with a fund, such as investment management fees. By contrast, the performance of the Fund reflects the deduction of the fund expenses, including sales charges if applicable. Investors can not invest directly in an index.

The performance of the Lipper Small-Cap Value Funds Index includes expenses associated with a mutual fund, such as investment management fees. These expenses are not identical to the expenses charged by the Fund.

Total return assumes reinvestment of dividends and capital gains distributions and reflects the deduction of any sales charges, where applicable. Performance may reflect the waiver of a portion of the Fund's advisory or administrative fees for certain periods since the inception date. If fees had not been waived, performance would have been less favorable.

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