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Overcoming Cognitive Biases: A Heuristic for Making Value Investing Decisions

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Notes

1. p. 54 of Graham and Dodd [1934]; see also Graham [2006], p 3.

2. See a partial list under "Well-known Value Investors." Retrieved from http://en.wikipedia.org/wiki/Value_investing

3. We would like to thank an anonymous reviewer for highlighting this aspect of Buffett-Munger value investing strategy.

4. See, for example, Athanassakos [2011], Chan and Lakonishok [2004], and Fama and French [1998].

5. O-S are the initials of the last names of the authors.

6. We recognize there is controversy in the psychology literature regarding heuristics perceived as a mental shortcut versus heuristics as an intuitive process using quick and associative processes to make judgments. We refer to heuristics as mental shortcut as the Gigerenzer school of thought (Gigerenzer [1996, 1997], Gigerenzer and Goldstein [1996]) and heuristics as an intuitive process as the Kahneman and Tversky school (Tversky and Kahneman [1974]). For purposes of this paper, we use the term "heuristics" in a generic sense to represent an informal, shorter, and faster approach to making … he norms of statistica …

7. See, f … or Baron [2008] w …

8. See T …

9. See …

10. S … : How Not To Be Your … y. Predicta … k: HarperC … ritings, speeche … es; but that is the su …

11. Chairman's letter tow the Shareholders of Berkshire Hathaway Inc., 1992, http://www.berkshirehathaway.com/letters/1992.html.

12. Chairman's letter to the Shareholders of Berkshire Hathaway Inc., 1992, http://www.berkshirehathaway.com/letters/1992.html.

13. Note that intrinsic value is an approximation, not a precise number.

14. We believe professionals who understand the logic of the heuristic can easily adapt it for use with small cap companies.

15. By earnings stability, we do not mean earnings smoothing rather earnings predictability as ascertained by a history of stable earnings.

16. Based on the fact that nominal U.S. stock returns averaged between 9% and 12% (7% real return) over a 200-year period. See, for example, Siegel [2002], especially chapters 2 and 12. 15% is also the rate of growth of book value that Warren Buffett has set as benchmark for Berkshire Hathaway.

17. This is in line with our estimate of long-term GDP growth rate. In the long-run (after the company has exhausted its competitive advantage), it will only grow at the rate of growth of GDP). 3% is the average steady state rate of growth of GDP for G-8 countries. According to the Bureau of Economic Analysis, historically, from 1947 until 2012, the U.S. GDP in March 1950 an

18. See ated.

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