Uncommon Sense for Beating the Odds: Financial Education for Wealth Creation

Arthur A. Nakano

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Abstract

There are some decisions that can be done with first-level thinking since all it requires is an opinion. It only looks for something that solves the immediate problem without considering the consequences. Almost everyone can do it because it doesn't require much thought. There are other decisions that require second-level thinking and are deep, complex and convoluted. These decisions look at future outcomes and seeing what others can't see. This paper will look at how advice from financial leaders can help individuals focus on second-level decisions for making prudent decisions.

Keywords: *financial education, investing, self-interest, motivation*

Introduction

"Think before you do! Don't ever be in haste to make a mistake, for that can be a big mistake! Think before you do!" [Yeboah, 2014] This quote is paramount in developing second-level thinking for better decision making.

Howard Marks, who is an American financial leader and author, has this to add:

> "The second-level thinker takes a great many things into account: · What is the range of likely future outcomes? · Which outcome do I think will occur? · What's the probability I'm right? · What does the consensus think? · How does my expectation differ from the consensus?" [Marks, 2013]

The graph from figure 1 illustrates the most likely connection with second-level thinking and successful outcomes. It can't be absolute since luck also plays a factor and is an "unknown unknown." [Rumsfeld, 2002] In

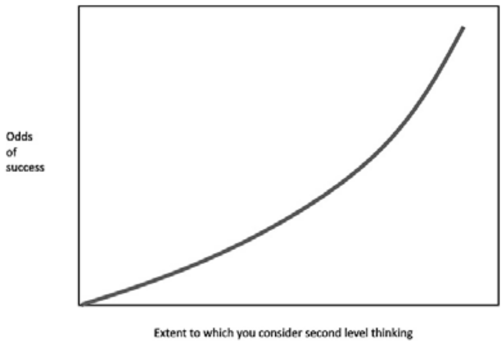

Figure 1. Second level thinking

general, second-level thinkers have a success advantage due to their thought process, but first-level thinkers without much thought process have luck on their side that can lead them be successful despite their lack of using any tangible cognitive ability. Let's take a look at an example of the graph by analyzing the details of a tweet made by Person A. Suppose Person A jokingly opines tweeting that eating a chocolate bar is a fantastic idea as a solution for hunger. Most adults would agree to some extent while knowing that this definitely is not an ideal answer. Young children, on the other spectrum, would exuberantly agree without hesitation since conceivably they lack the knowledge about the detrimental effects of sugar. In this case, Person A is operating at first-level thinking and looking only for immediate satisfaction from the tweet. This highlights the point of the graph because if Person A had been using second-level thinking, then a more thoughtfully worded tweet would have been written to consider the broader audience; in particular, the younger audience and the parents of those younger audience. Operating at first-level thinking is not imprudent when dealing with one's own situation, otherwise the many daily decision in life would drive one to madness, but when dealing with an audience, second-level thinking should be at the forefront.

> "First-level thinkers look for simple formulas and easy answers. Second-level thinkers know that success in investing is the antithesis of simple." [Marks, 2013]

Second-level thinkers look at imaginable future outcomes. They look at the ramifications of how situations may possibly develop and patiently think before acting. After all, if you only eat chocolate bars when you are hungry then this may lead to disastrous health consequences.

In a quest for wealth creation, learning about second-level thinking can serve as a building block for personal financial education. In particular, when investing in the stock market and the opportunities and catastrophes that await.

> "An area in finance that seems to always draw some attention is investing in the stock market. According to Forbes, in 2020, around 50% of American households owned stocks, most of which had been purchased through a mutual fund that invest in a broad basket of stocks." [Nakano, 2021]

Mr. Market, a character popularized by Benjamin Graham in his timeless classic, The Intelligent Investor, is a schizophrenic investor that switches from manic-depressive, and optimistic-pessimistic states. Since the stock market is comprised of these types of investors, the market as a whole frequently takes on these characteristics.

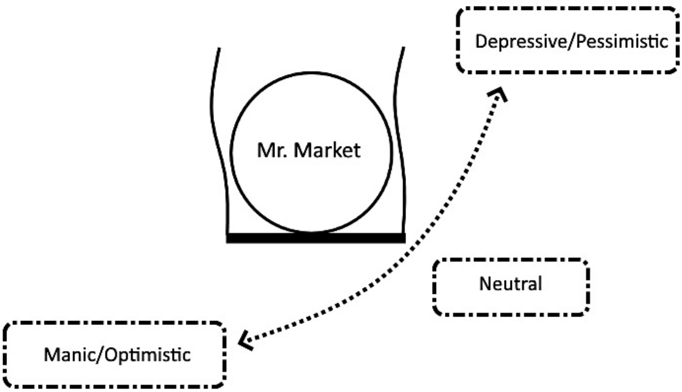

Figure 2. Mr. Market fluctuations

Surprisingly or unsurprisingly to a few, Mr. Market tends to spend little time in the middle and is oriented at either end. The emotional dichotomy of greed and fear, which accompanies Mr. Market, intermittently allows for huge fluctuations of equity prices; often times even if the fundamentals of a company or index barely changes. How can applying second-level thinking to Mr. Market be beneficial in reaching a prudent outcome?

Engaging in second level thinking

> "The one who follows the crowd will usually get no further than the crowd. The one who walks alone is likely to find themselves in places no one has ever been before." Albert Einstein

Following the crowd is a euphemism that almost everyone has heard of and in the world of stock investing, one need to look no further than where the money is being channeled. Equities that have suddenly seen a surge of incoming funds see their stock price soar and get the attention of investors. Individual investors, who suddenly become aware of a large institution investing in a company, see this as an opportunity to get on board for greater gains. In this case, the individual investor is displaying herd behavior and using only first-level thinking. They opine that the stock is going up due to institutional investing, so they must invest into the company.

> "You can't do the same things others do and expect to outperform." [Marks, 2013]
> "It appears to me that much of the decision making that goes on in Wall Street is System 1 thinking. It operates mainly by intuition. Decisions are made automatically and quickly with little or no time for thoughtful reflection." [Swedroe, 2012]

Herding behavior may seem to provide a good safe direction, but the resulting performance will be the same as the herd. Sometimes the direction can be correct and lead investors to a fertile land and other times it can lead them to a cliff.

Developing second-level thinking requires taking time to look beyond the palpable and assess the situation in all directions. Investors need to plan for the knowns and unknowns in individual equities since this involves taking unavoidable risk. The risk that is most detrimental to investors is the loss of capital since it has a disproportionate disadvantage; investors losing 20% of their capital will be required to gain 25% to recover from the loss. Individual investors should mitigate risk by assessing Marks' [Marks, 2013] question, "What does the consensus think?", as part of being second-level thinkers.

A bullish sentiment

A bullish sentiment is when investors are purchasing the stock and inflating the price due to some known and/or unknown information. Known information, usually those that are released through the company's quarterly reports, like earnings growth or increased revenue forecast often lead the way for the bulls.

When financial analysts look at the quarterly report of a company and see that it is growing earnings then the price of the stock will most likely be raised to keep in check with the price to earnings ratio. The price to earnings ratio (henceforth known as PE) is the most well-known indicator for stocks since it displays the current stock price to its earnings. "Of all the possible routes to investment profit, buying cheap is clearly the most reliable" states Marks. [Marks, 2013] If a stock's PE shows it is undervalued compared to the sector it is in and yet it is growing its earning then that would be a point for recommending to buy the stock.

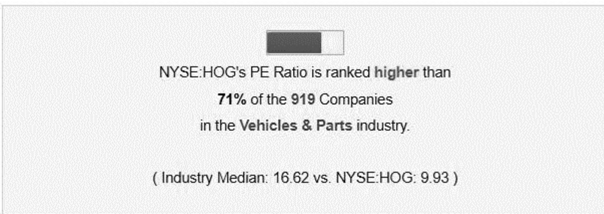

Figure 3. Hog's PE is below the sector median [Harley Davidson PE Ratio, 2022]

The bulls were behind a 20 percent price rally for Harley-Davidson (HOG) when the company reported a $0.15 per share adjusted profit for the fourth quarter, handily beating analyst forecasts of a $0.38 per share loss and a complete reversal of the $0.68 per share loss it recorded a year ago.

Unknown information, which is most likely known to just a few, such as a potential takeover bid or new technological developments also start the charging bulls. When unknown news like a takeover bid is released to

Figure 4. Hog stock after earnings surprise [Google Finance, 2022]

the press, the focus many investors look at is the takeover bid price and the current price. If the current price is discounted from the bid price, then the bull charge will begin in earnest since a quick gain can be had.

First-level thinkers would jump on the bullish consensus and deploy capital to try and gain an advantage. This may reward them if they are quick to realize that an opportunity is being presented even if they might not realize the cause for the bullish sentiment. Second-level thinkers on the contrary, patiently assess the situation and then form a stance of the bullish consensus. Mark [Marks, 2013] declares that "The most dangerous investment conditions generally stem from psychology that's too positive."

In the previously mentioned case of known information, earning growth is important but other areas of the financial statement should not be disregarded. If a company grows its earnings but takes on huge debt to finance itself then that should be measured. This kind of financial statements often characterizes small growth companies that have yet to establish themselves in the market and are spending tremendously on research and development. Second-level thinkers also look at unknown information and ask themselves, "Which outcome do I think will occur?" If a takeover bid is making the headline, they might wonder about the likelihood of it actually going through. There could be regulations from the Security and Exchange Committee that is being overlooked and may prevent the takeover from moving forward. Also, second-level thinkers think about the time value of money since that will result in opportunity cost. If the takeover will be in two years, and the percentage gain is 14%, will that result beat other investment prospects that may present itself during the holding period.

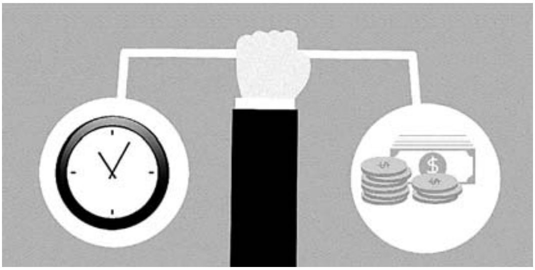

Figure 5. Opportunity cost [Dikov, 2022]

A bearish sentiment

At the opposite end of the bullish sentiment is the bearish sentiment. This develops when investors bail out of a stock causing the price to descend, sometimes at a torrid pace. Daniel Kahneman [Kahneman, 2011], a Nobel winning economist and author, believes because of loss aversion, a phenomenon where a real or potential loss is perceived by individuals as psychologically or emotionally more severe than an equivalent gain, people tend to overreact to bad news and react slowly to good news.

As with the bullish sentiment, the known and unknown information usually drive the bearish sentiment. Taking a look at the previously mentioned quarterly report as a known indicator, financial analyst might see that a company has missed its expected earnings and also has decreased its net revenue. This duality of bad news will likely have the analyst weaken their endorsement of the company and mark the appearance of the bears. If the figures that the company has reported seem decidedly different from the expectations, the company's stock will be engulfed by the bears and cause a panic driven sell-off.

Even large capital companies such as Meta (formerly known as Facebook) aren't immune to colossal losses if expectations aren't met. The following figure shows a sell-off representing a 26% decline in the stock, which is equivalent to a one-day record setting 230 billion USD, for missing earnings estimates for the fourth quarter at $3.67 vs. $3.84 that analysts were expecting. Even with the actual and expected estimates not particularly dissimilar, the company stock went into a freefall led by the mighty bears.

Figure 6. Meta stock after reporting a rare profit decline [Google Finance, 2022]

In the realm of unknown information, if a company's once known takeover bid has suddenly and unsuspectingly been averted due to the board of directors rejecting the offer, the price of the stock will certainly take a fall since the euphoria that the news brought will disappear and make it appear less attractive for those investors looking to make a swift profit.

> "Just as herding induces investors to take greater and greater risks during periods of euphoria, so the same behavior often leads many investors simultaneously to throw in the towel when pessimism is rampant." [Malkiel, 2003]

For second-level thinkers, the bearish sentiment that was induced by Meta's known earning's miss and the dramatic price fall, it could inspire them to look deeper into the situation. Since records of quarterly reports are readily available, the history of Meta's earnings can be analyzed to see if this earning's miscue should be considered. When looking back at the past three years of Meta's earnings, it can be easily seen this is an anomaly and hasn't been a recurring incident. The only other quarter that Meta's missed earnings was in FQ4 in 2019 and that was by just one cent even though its revenue grew by over 24 percent.

Earnings History

Period	EPS	Beat / Miss	Revenue	YoY	Beat / Miss
FQ4 2021 (Dec 2021)	3.67	-0.15	33.67B	19.95%	230.60M
FQ3 2021 (Sep 2021)	3.22	0.04	29.01B	35.12%	-513.23M
FQ2 2021 (Jun 2021)	3.61	0.55	29.08B	55.60%	1.19B
FQ1 2021 (Mar 2021)	3.30	0.96	26.17B	47.55%	2.46B
FQ4 2020 (Dec 2020)	3.88	0.64	28.07B	33.16%	1.64B
FQ3 2020 (Sep 2020)	2.40	0.49	21.47B	21.63%	1.67B
FQ2 2020 (Jun 2020)	1.80	0.43	18.69B	10.67%	1.33B
FQ1 2020 (Mar 2020)	1.71	0.01	17.74B	17.64%	524.77M
FQ4 2019 (Dec 2019)	2.56	-0.01	21.08B	24.64%	184.79M
FQ3 2019 (Sep 2019)	2.12	0.24	17.65B	28.59%	301.62M
FQ2 2019 (Jun 2019)	1.99	0.11	16.89B	27.62%	392.99M
FQ1 2019 (Mar 2019)	1.89	0.29	15.08B	26.00%	103.14M

Figure 7. Meta's earnings history [Seeking Alpha FB earnings, 2022]

A second-level thinker might also delve into the net income of the company to see how profitable or unprofitable it is. Having a strong balance sheet, which includes positive net income, is one item in a checklist when looking to purchase stocks. [Lynch, 2000] In the case of Meta, it is readily apparent that the company has a growing net income and is extremely profitable in the social media sector that it operates in including Facebook, Instagram, WhatsApp, and Messenger. They also function in another sector, called Reality Labs, that appears to be focusing on future growth by looking at augmented and virtual reality. In other words, the company is trying not to become stagnant and instead look toward the next possible paradigm shift.

Cash Flow Statement	Dec 2017	Dec 2018	Dec 2019	Dec 2020	Dec 2021	TTM
Net Income						
Net Income	15,934.0	22,112.0	18,485.0	29,146.0	39,370.0	39,370.0

Figure 8. Meta net income (in millions of USD) [Seeking Alpha FB earnings, 2022]

As for investing in Meta stock, second-level thinkers will likely consider the forementioned two financial elements as well as other information to decide if this is a sensible time to allocate their funds. The point being that forming a prompt conclusion would not be the best idea when analyzing the known information that is being presented.

This also holds true for unknown information of a company. When a company declines a takeover bid that was being offered, most first-level thinkers would opine that a quick exit is necessary due to this unknown and unexpected change. This will indisputably send the price of the stock in a downward track as money is pulled from the investors. The following figure shows Illumina stock when the announcement of a takeover bid was announced by Roche Holding AG in January 2012 and then later terminated in April 2012 due to Illumina shareholders being unhappy with the arrangement.

Figure 9. Illumina stock takeover bid timeline

Illumina develops, manufactures, and markets integrated systems for the analysis of genetic variation and biological function. This is certainly a highly specialized market and most investors would need to do a fair amount of research to find out about the company's direction and potential. For the shareholders who kept their stocks, even after the terminated takeover bid, their loyalty in the company seemed to be a bad decision for about a year. Second-level thinkers would look at the failed takeover bid and the bearish stock dip and give serious thought about the company by spending time to learn about its business and the growth potential. Despite the rejected takeover bid, the fundamentals of the company hadn't strayed so the value of being patient and allowing the stock price to be synchronized by the market could be of particular interest for getting alpha.

> The controlling variable for both speculators and investors is the time horizon. Speculators work in short-horizon periods and accept smaller returns. Investors operate over long-horizon periods and expect larger returns. [Swedroe, 2012]

Illumina's stock price initially had a 24% decline after the takeover bid was terminated and was in a flux like state for about a year, but then it steadily started rising and in April 2014, which was two years after the failed takeover bid, had shown a 264% gain. In other words, the offer of $51 that Roche Holding AG had announced, would give Illumina first-level thinkers a 30% gain had they reacted quickly enough to the news about a potential takeover bid. Following along the first-level thinkers thought process of exiting after the deal had been terminated, this at best gave them a gain of 30% if they were able to get out at the top, which surely is difficult to do.

> A market timer tries to predict the short-term zigs and zags in stock prices, hoping to get out with a quick profit. Few people can make money at this, and nobody has come up with a foolproof method. [Lynch, 1996]

Second-level thinkers, who had given careful attention to the company and decided that fortitude was needed to see the equilibration of the price and the potential of the company's growth, were rewarded dutifully with an approximately nine times larger percentage gain for waiting two years.

Conclusion

Howard Marks has stated that, "Superior investing, as I hope I've convinced you by now, requires second-level thinking-a way of thinking that's different from that of others, more complex and more insightful." [Marks, 2013] If individual investors apply second-level thinking to analyze their equity investments then the odds of their success will be greater. Certainly, luck can't be discounted, but in the absence of luck, forming slow and patient decisions using known information as well as scrutinizing unknown and unexpected information can lead to an advantage. Bullish and bearish sentiment are often caused by herd behavior since "investor attitudes and behavior, spend only a small portion of the time at 'the happy medium.'" [Marks, 2013] In the end, operating at first-level thinking and only eating chocolate when you are hungry can cause heartburn, migraines, osteoporosis, kidney stones, weight gain, clogged arteries and diabetes. "Think before you do! Don't ever be in haste to make a mistake, for that can be a big mistake! Think before you do!" [Yeboah, 2014] Or in other words, if you are capable, try to use second-level thinking!

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