The Little Book of Behavioral Investing

Author: James Montier

This handcrafted book summary will help you learn

• How you can be your worst enemy when it comes to investing
• What are the various human biases that trip you when investing?
• What is the best investment strategy?
• How to spot a bubble (and avoid it)?

In *The Little Book of Behavioural Investing*, expert James Montier takes you through some of the most important behavioural challenges faced by investors. Montier reveals that the most common psychological barriers, clearly showing how emotion, overconfidence, and a multitude of other behavioural traits, can affect investment decision–making.

Bias, emotion, and overconfidence are just three of the many behavioural traits that can lead investors to lose money or achieve lower returns. Behavioural finance, which recognizes that there is a psychological element to all investor decision–making, can help you overcome this obstacle.

There's no winter coming...

Humans are inherently optimistic. We hold an extremely high belief in ourselves- as students or as professionals, and as investors. An illusion of control further complicates this elevated sense of self.
It has been found that people are willing to pay four times the price of a lottery ticket when given the flexibility of choosing the numbers in the ticket. From a mathematical probability perspective, nothing much has changed. However, the illusion of control provided by 'selecting the numbers' makes the lottery ticket buyer think that he has a higher chance of winning because he (or she) can personally select the numbers in the ticket.

Quiz Time

Let's begin with a quiz question: *'A bat and a ball together cost $1.10 in total. The bat costs a dollar more than the ball. How much does the ball cost?'*

What is your answer?

Did you answer $0.10? Or did you figure out the correct answer, which is $0.05? This question is one of the three questions asked in the Cognitive Reflection test, which is considered more difficult than most IQ or SAT tests. Why do most of us see this question as a simple question and jump to the (wrong) answer of $0.10? Why do we jump to conclusions, when spending a few seconds thinking through would lead us to the correct answer? **This has got to do with how our brain thinks. This is the X system of information processing that the brain indulges in.** X system is the brain's default mode of operation. The X system comes into play automatically and without much effort and is often behind our emotional responses.
If you took some time and answered the bat and ball question as $0.05, you held back your default X thinking system and got the C system to work for you. **The C system of the brain is the logical system. It requires more deliberate effort to get the C system to work for you.** In trying to think logically, the C system gets slowed down and therefore is slower as compared to the default X system.

Is optimism a good investment strategy?

Our high sense of self-esteem and optimism is the X system at work. The X system of thinking dates back to our ancestors when life was more difficult in terms of risk to life. Optimism was a survival strategy for our ancestors. However, optimism is not a good strategy for modern day investors.

In fact, **over-optimism is a bane for investors.** Being sceptical and questioning optimistic scenarios is possibly the best investment strategy. Indeed, the best investors ask themselves *'Why should I own this stock?' rather than 'Why shouldn't I own this stock?'*

Procrastination & the investor

Empathy gap is defined as the inability to predict our behaviour in the future, when we may be under emotional stress. The familiar feeling that you will never eat so much again, after an unusually heavy meal, is an example of an empathy gap. Having overeaten then, you feel that you will never overeat again in the future. A resolve that gets broken the next time you are starving, and there is a delicious spread laid out for you.

Procrastination is the most significant reason for empathy gaps. When the deadline is far away, you are unable to predict how you will do your project at the last moment. Moreover, that is precisely what most of us end up doing-finishing our work under extreme stress at the last minute, thereby turning in suboptimal quality work.

In the world of investments, this translates into making errors in investment decisions, which can then lead to massive losses for you and your customers.

The solution to this lies in what is known as *pre-commitment*. For investors, this translates into two steps:

- Plan your investment when you are not agitated or when the markets are not volatile
- Pre-commit yourself to the action points devised using the planning step above

As Sir John Templeton said *'The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell'.*

In March 2009, the S&P 500 was down by 57% from its peak level in 2007. In such a doomsday type scenario, *terminal paralysis* sets in the markets. People hold on to their cash while those over-invested in the market freeze. The only way to overcome *terminal paralysis* is to stick to your pre-committed plan that you devised when things were *'normal'.*

Trust me, I am an expert!

Like optimism, **investors should be aware of experts**. Humans tend to confuse confidence with skill. The general belief is that if someone is extremely confident, he or she must be good! Moreover, it has been proven in psychology studies that experts are more overconfident than the rest of us.

In a group of weathermen and doctors, the weathermen turned out to be more confident of their predictions-when the weathermen predict they will be right 50% of the time, they were. However, doctors in such studies predicted that they would be right 90% of the time, only to find that they were right just 15% of the time. **This disparity happens because we prefer doctors who are confident, thereby egging doctors to be more confident than they are.** Will we go to a doctor who is not sure of his diagnosis? Probably not.

I predict a five-fold return on your money

So, are fund managers weathermen or doctors? Unfortunately, it turns out that fund managers leave doctors far behind when it comes to demonstrating overconfidence in their predictions. **Indeed, the illusion of being an 'expert' drives their overconfidence, which others confuse with skill, thus believing in experts.** This gets further complicated when you add the 'ability to forecast' to the 'expertise' of these experts. It is safe to assume with a certain level of confidence that forecasting is more about overconfidence than a genuine skill set.

Predicting the future in the world of investment is *'sheer madness.'* If forecasting is of no practical use, then why do we keep doing forecasts? In one of the most exhaustive studies done on forecasting, Philip Tetlock found that across a wide range of forecasts, **the experts were marginally better than someone who can make forecasts using just the toss of a coin.** In such scenario, why should we depend on forecasting? Moreover, by the way, isn't Discounted Cash Flow (DCF) a forecasting method?

Is DCF a wrong analysis tool then?

The answer is that there are better methods than DCF. The reverse-engineered DCF where instead of forecasting the future, you take the current market price and understand what it implies for future growth, is a better method. Another alternative is the Greenwald Approach that compares asset value to earnings power value and then builds a view of the intrinsic value.

The third option to standard DCF is what Howard Marks of Oaktree Capital believes *in-instead of predicting cycles, prepare for them, not in the context of predicting(or forecasting) the cycle but understanding your present position in the context of the cycle, i.e. knowing where you are in the cycle.*

Our analysis captures million data points!

Does more information lead to better investment decisions? To rephrase, does the adage less is more hold for the world of investment decisions? **Studies have shown that decisions are taken faster and more accurately when a lesser amount of information is available.** Having more information just increases the confidence of the decision maker and confidence, as we saw earlier, can often be mistaken for skills.

As investors, it is essential to separate the signal from the noise. The leading expert in separating signal from the noise is **Warren Buffet**. Buffet does not look into in-depth data analysis of the next quarter projections. Instead, he looks for underlying economic and financial fundamentals when evaluating an investment decision.

In all likelihood, valuation of a stock, its balance sheet and the discipline of the board managing the cash on behalf of the stock are good enough for most investment decisions. **You might not feel confident making decisions with just these three parameters, but that is what information overload does to you- it makes you feel confident when you should not be.** TV analysts thrive on confidence perpetuated by an information overload. Not peeking into the TV screen or your Bloomberg terminal may be a wise investment decision.

Surprise me because I hate shocks

Confirmation bias is another enemy of making rational investment decisions. Confirmation bias is about selectively looking for information that supports our views or beliefs. Excellent fund managers or investment analysts will consciously look for evidence or information that proves their analysis wrong. Remember *'Why should I buy this stock' vs 'Why shouldn't I buy this stock?'*

Bruce Berkowitz of Fairholme Capital Management says he 'tries to kill the company' when he evaluates it for investment. Instead of looking for information that supports the investment decision, Berkowitz and his team do the exact opposite. They look for information on what would make the company collapse. Berkowitz makes extraordinary effort to be surprised by the upside rather than shocked by the downside.

But I have put so much money in this!

A good practice followed by most successful investors is to revisit their investment decisions at regular intervals, and make changes (including a complete write-off, if needed) when necessary. **A trap that the not so successful investors fall into is the *'sunk cost'* fallacy,** which makes them stick to an earlier position or decision simply because a lot of time and money has been invested into that decision. Being a permanent bear or a permanent bull is about falling into the *'sunk cost fallacy'* trap.

I am hopeful this scrip will grow

As we saw earlier, optimism (or hope) is the survival strategy for humans from the cave-man days. However, optimism is not necessarily good when applied to investment decisions, and can be utterly disastrous if as an investor, you are paying a premium for the hope of growth of the stock.

Paying a premium for the hope of growth is a mistake often committed when an Initial Public Offering (IPO) rolls out. Research indicates that in the US, the average IPO has underperformed the market by 21% in the first three years of the IPO rolling out.

Should you, then, believe in hope as an investment strategy? What is the recommendation then? As an investor, go back to the basics, stick to facts, and let your brain do the hard work of the C system. That is what **Ben Graham** suggested in 1934, and it holds true even today.

Wow, it's a bubble!

A bubble, in its strictest sense, is defined as price movement that is at least two standard deviations from the trend. Statistically, as per the efficient markets hypothesis, this should happen every 44 years. However, there have been more than 30 bubbles since 1925! **How can we, then, believe that markets are efficient?**

Bubbles are actually *'predictable surprises'* that explode into a crisis, because the few people who were aware of the problems that led to the bubble, did not act on it. For every bubble, there is always a set of people who caution against the bubble. However, **the challenge is not in predicting the bubble, but in predicting the timing of when the bubble will burst** and become a crisis. Hence, the term predictable surprise. People predict a bubble but are surprised by the timing of the bubble burst.

I was sure this bubble will not burst

So why are we unable to tackle these predictable surprises well in time? There are five reasons behind this behaviour:

1. The over-optimism that we discussed earlier. We believe in looking at the bright side- others get divorced, I do not. ***Similarly, others get caught in a bubble burst; I will not.***
2. The illusion of control that we carry within ourselves. TV channels churn out analysis that makes us believe that we have quantified the risk and therefore things are well within control. Only to get a nasty surprise later.
3. The self-serving and self-confirmation bias that makes us believe only in information that meets our interests. **As Warren Buffet said *'Never ask a barber if you need a haircut.'***
4. We prefer spending more time making choices that are geared towards the short term. When we make a decision that will bear result only in the future, we do not put too much of thought into it. However, when we make a decision where the consequences are in the near future, maybe next week, we think through our choices with much more thought.
5. Finally, we miss spotting the bubble because we are not looking for it! We are so enthralled by the bubble that we are not looking at the evidence of it bursting anytime soon. Behavioural economics terms this as **inattentional blindness.**

The four most dangerous words in investing

Experts in the analysis of bubbles believe that an 1867 paper by John Stuart Mill is the best framework to understand a bubble. The bubble framework based on Mill's paper captures the five stages of a bubble:
1. Displacement: This is the creation of profit opportunity, which though slow in the pace of growth, is the first stage of a bubble creation. The slow growth makes most people miss it, but there are a few early spotters who have got in at this stage of the bubble

2. Credit creation: Credit creation acts like oxygen for the bubble.The credit required to 'nurture' the bubble can come from various sources including money from banks, the creation of new credit instruments or scaling up of non-bank credit.

3. Euphoria: This is where over-optimism comes in to make the bubble bigger. At this stage, nothing about the bubble is wrong. All the behavioural economics concepts of optimism, self-serving bias, myopia and inattentional blindness start manifesting themselves at scale. The common belief, as Sir John Templeton said, is 'This time is different'. Those are the most dangerous four words in investing.

4. Financial distress: This is the stage where the people who are aware of the problems behind the bubble, the insiders, start cashing out. Instances of fraud emerge, and the excessive leverage built during the earlier phases of the bubble leads to a crisis.

5. Revulsion: the final stage in the life of a bubble is where scarred investors decide to exit the bubble sector, or the market completely. This leads to a crash and resultant bargain price for the assets involved in the bubble. As Mill wrote 'Panics do not destroy capital; they merely reveal the extent to which it has been previously destroyed by its betrayal into hopelessly unproductive works'.

Bubbles are formed due to human behaviour, and the good news is that human behaviour is predictable.

Don't move!

In the 1950s & 1960s, the average holding period of stocks by investors was about 7-8 years. However, today, the average stock holding period on the NYSE is just six months. Being myopic and thinking only for the short term is a malaise in the investing world today. **In addition to this myopia, things get complicated by the need to keep showing that the fund manager is not sitting idle. Instead, she or he is busy taking steps to help your money grow.**

In reality, the best thing to be done is to leave the portfolio alone. We see action bias as a positive thing. Research has shown that during penalty shoot-outs in soccer, the goalkeeper would have saved more goals by standing still at the centre of the goal, instead of jumping left or right. Yet, the goalkeeper is expected to *show action by jumping left or right.*

What should the investor do instead? **The opposite of action bias is not inaction, but patience.** Patience and discipline are the best friends of an investor. Traders believe in action bias, investors believe in patience and discipline.

Walk the path alone

Neuroscientists have found that there is fear and pain associated with the thought of going against the crowd. Brain scans show that when the thought of going against the crowd crops up, the amygdala portion of the brain becomes active. Amygdala is the part of the brain that processes emotions and fear. Being contrarian requires you to activate your brain's C-system, which requires much deliberate effort.

The contrarian investor

As a contrarian investor, you go against the crowd. **When others buy, you sell. When others sell, you buy**. A note of caution is required here- due to our high sense of self-esteem and optimism, we all believe that we are the contrarians, and others conform to the herd. More often than not, we are mistaken and this belief of being a contrarian when we are not comes from a lack of introspection of our actions. **Being a true contrarian in our lives, and as investors requires the following deliberate behaviour:**

- Demonstrate the courage to go against conventional wisdom and groupthink
- Practice critical and independent thinking before making choices, including your investment decisions
- Be disciplined enough to stick to the path of being a contrarian. Grit matters.

When do I sell?

The best way to decide when to sell is to stop focusing on the short-term. **The more you keep checking your portfolio, the more short-term loss scenarios will emerge, which will make you sell.** As human beings, we are averse to losses and like to cut our losses as much as possible. When you keep checking your portfolio, you end up looking at short-term losses, thereby succumbing to the need to cut your losses by selling. If you have done your research well, your portfolio should not require a second-by-second monitoring.

Researchers believe that the endowment effect plays a critical role on our decision to buy or sell. The endowment effect happens when you, as compared to others, attach a higher value to something that you own.

If you own a bottle of wine whose price has appreciated ten folds in the past few years, will you sell the wine bottle? The most common answer is a No. Will you now buy a similar wine bottle at ten times the price? The answer in most cases is, again, a No. This is the endowment effect in play. Reluctance to sell is a common behaviour of investors who are swayed by emotions and biases.

Focus on the process, not the result

The need to focus on the process rather than the result is the adage that successful investors should swear by. Too much focus on the results leads to sub-optimal choices on account of a desire to reduce losses and avoid ambiguity. **Instead, focusing on the process leads to better decisions, and higher long term returns.**

As Ben Graham said 'The value approach is inherently sound, devote yourself to that principle. Stick to it, and do not be led astray'. **The best investors in the world, including Warren Buffet, Bruce Berkowitz, John Templeton and many others have built their own processes or heuristics to arrive at a sound investment decision.** The only person standing between you and successful investment decisions is you, and your errors and biases.

Get your C-system to consciously think and avoid the biases.

As human beings, we often end up reacting to situations in an emotional manner. However, you must already know that in order to make the right investment decisions, you must remove emotions from the equation and control the impact of your behavioural biases. Of course, that is easier said than done. And, you know, a great way to overcome many of your behavioural biases is to invest in Balanced Advantage mutual funds. These are basically categorised as hybrid mutual funds which means that they invest in both debt and equity instruments. What makes them different and especially helpful in overcoming behavioural biases is their ability to keep changing the portfolio exposure from one investment type to another based on how well the investment is doing and the general market environment. They are able to do this simply because they are usually process driven and hence, behavioural and emotional biases do not impact the decision making process. The key here is that the shift in portfolio exposure from one investment type to another, for example, from debt to equity, is done based on a predetermined investment strategy and triggers. This significantly reduces the impact of even the fund managers' biases in investment decision making. For you as an investor, this automatic movement between debt and equity is great as it takes away the burden of deciding how to invest and when to invest.