Decision-Making: The Last Frontier in Investing Skills

My investing plan is heavily, but not exclusively, focused on stock price charts. This is because my experience has taught me that being able to find good companies is the easy part. What is not so easy is getting the timing right.

The fundamental ratios tell us what the company has done in the past. This is important because it is the best guide we have of the quality of the management of the company and relative value of the company at the present price. It must be remembered that the fundamentals are always history. On the other hand, on the stock markets people are buying and selling shares based, not on the past, but on their expectations for the future. Commonly this future is nine to twelve months ahead of the present time.

The stock price charts also record history. However, they are more up-to-the-minute than half-yearly or quarterly financial statements. The price at which shares change hands today can give us a good idea of what the smart money – those who know a lot more than we do about the company – is thinking about expectations of the future. Their actions are weighted to their resources, but also to the strength of their conviction about their expectations. The greater their conviction about their view, the more weight of money will be behind their actions. It is the weight of money that moves prices.

The charts therefore serve two purposes:

1. If the fundamentals appear favourable and the price is trending up, then the smart money is putting resources behind an expectation that the price of the shares should be re-rated upwards.
2. If the fundamentals appear favourable and the price is not trending up, it is a warning that the smart money may know something is not right or has changed since the last fundamental data. This may be that the conditions were favourable for the company, but the forward expectations of those close to the company think that situation will become worse.

My experience has shown me the hard way that the best investments have fundamental ratios that indicate good value while the share price is breaking out upwards from accumulation/consolidation phases, or is already trending.

The interesting conclusion from this is that investing really is not that difficult. What causes people to lose money is a lack of discipline in the way they choose and time their investments. This is followed by a lack of discipline in cutting short the investments which do not succeed while letting the good investments grow in value and throw off increasing dividend income. Investing is not difficult, but ***we*** make it difficult because we do not always act rationally and exercise the necessary discipline.

Many of the mistakes that beginners make go back to the way they make decisions. All of us – and I continue to learn myself – fall into decision making traps. The difficult part of this is that these illogical ways of thinking are basically unconscious. In short, we do what seems natural, but is actually irrational if only we could see that. This is where behavioural finance has opened our eyes in the last fifty years. The academics who have done the pioneering work in this field have, some of them, won Nobel prizes. However, we have been the real winners if only we accepted that this is an area we needed to study.

I often talk about decision making as the final frontier in the education of an investor. First, we learn the knowledge. Then we begin to gain experience in using that knowledge in the markets. We rarely succeed for long. Then we discover money management. This is very important and can protect us from even the weakest of our investment decisions.

Then those of us who started from fundamental analysis discover charting and technical analysis. At the same time, those of us who started from charting and technical analysis discover fundamental ratios. We are enriched as investors from this expansion of the tools we have to work with.

Now we come to the last frontier – ***us***. We start slowly to realise that it is not only our analysis that determines our results. Money management protects us from poor decisions. However, the trick is to make better decisions. Now we are at the last frontier – decision making. We realise that many of our poor investments were due to poor decision making skills.

The problem with decision making is that it seems so natural. We collect all the available evidence and decide what to do. What we have to grasp is the unconscious process that is encapsulated in that little word "decide". The last frontier is when we start to become aware that we may be lacking in decision making skills.

This is where behavioural finance comes in. The researchers in this field have tried to dig below the surface to find how humans actually make decisions. This leads to fascinating discoveries about how we are hugely irrational in what we all do unconsciously.

If you find this confronting – that it is you that is the problem – try to move past it. The very first step is to become aware of the logic traps and biases that we all have. Once we can recognise that and start to see ourselves falling into the traps, we are most of the way there. So, do not be afraid of this, it may be the final step you need to take if you are ever to be a really good decision maker in the investment field.

The problem with this field of knowledge is that most of it is in academic papers that are written in language most of us find difficult to understand. I have tried to write much of it up in a simple way in my book *Think Like the Great Investors*, with strategies for improving our investment decision-making skills.

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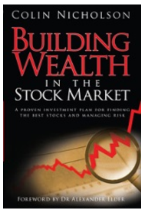

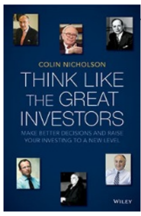

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