Improve Your Decision-Making Skills

There is an important difference between the analysis of markets or stocks and the task of implementing the resulting ideas as an investor. Most beginners think that analysis is all there is to investing. They think that the analysis process will throw up the best stocks to buy. Further, that the choice of what to buy and when to buy it is all that is required. What is more, beginners tend to think that the analysis is the difficult task and everything after that is easy.

The problem here is that this is incorrect thinking. Analysis throws up prospects. Investors then have to decide which of the prospects to act upon and what is the best time to act. Moreover, it does not end there. The investments must be managed. Buying stocks is often the easy part of the whole investing process. The tough part is managing the investments through to the final sale at either a profit or a loss. Every time new information becomes available, decisions have to be made.

New information in the form of prices comes along every day the market is open. In addition, there will be lots of news about the stocks, the industry the stocks are in, the overall market and the economy. Even international news can affect local investments.

For this reason, the essential nature of investing should be viewed as serial decision making. Every time a new piece of information comes to the attention of an investor, a decision must be made, even if it is simply to do nothing.

Much of the time, these decisions will be easy to make. The new information may not greatly change anything. However, sometimes the new information quite dramatically changes the situation. Then, difficult choices may have to be made.

The Systematic Approach

When tough decisions are called for, common sense suggests that investors should ideally try to adopt a systematic and rational approach. However, this is something that most investors do not do very well, if at all.

The steps to making rational decisions are well described in the textbooks and consist typically of a series of steps:

1. Make a clear statement of why a decision is needed in terms of what we want to achieve. It should be noted that this is a two-part step. First, there should be careful consideration of the need to make any decision at all. Many poor decisions may have been totally unnecessary or aimed at the wrong problem. Second, it tends always to be the case that a lack of clarity about objectives leads to the making of poorly focused decisions which miss the main issues.

2. List all the factors that we think are important in making the decision. Most people naturally jump straight from the realisation that there is a problem to deciding what should be done. This is a very human response, which should be resisted. Having decided on the need for a decision and having set up clear objectives, an absolutely essential second step is to set out everything which should be considered. The

great value in this step is that it helps avoid a common mistake. This is when a seemingly sound decision is made without consideration of a vital aspect of the problem or situation.

3. Assign a percentage importance weighting to each factor. Clearly some factors are more important than others. In order to make a sound decision, it is useful to arrange the factors in order of importance. It is also desirable to attach a value to each factor which reflects, as closely as can be estimated, the weight to be attached to each factor.

4. Search out and list all the options open to us. A common technique used at this stage is brainstorming. This involves deliberately avoiding the formation of early conclusions. Instead, the idea is to range as widely as possible, recording any and all options which are suggested. Avoid arguing for or against them. At this stage, simply assemble a list of ideas.

5. For each option, evaluate it in terms of each factor and assign a rating depending on how well it meets our objectives. This initially involves research of what is involved in each option. Once the research is done comes the stage where the ideas are independently assessed. This process will have regard to the factors listed in step 2, using the weightings which were developed in step 3.

6. Total the score for each option and go with the one with the highest score. The total score will reflect the relevance of each option in terms of solving the problem. Clearly the one with the highest score will be the one which best meets the objective.

In investing, this systematic method is excellent for deciding which stock or stocks should be bought when investment funds are insufficient to buy all of the opportunities which are presenting themselves at that time.

The other common issue which all investors face at some time is deciding whether to continue to hold a losing investment or switch into another stock or into cash. The systematic method is ideal for dealing with this very emotionally charged problem. Most investors seem to decide that it is just too difficult and cannot face taking a loss. One of the good ways to get the mind around this is to use the systematic method to place a score on each of the alternatives. This is quite often a way to break through the barrier of taking a loss, something which is rarely a problem for successful investors.

Now the Real World

Having described the ideal process, it must be stressed that few people will ever attain this for investing decisions. Nevertheless, it is important to have a picture of the most desirable approach and to work towards implementing it as far as possible in the search for rational decision making.

What most investors, even highly professional ones, do most of the time falls far short of this ideal. This is not simply because they are lazy, in fact far from it. The issue is that there are only so many hours in a day and in order to make all of the decisions needed in investing, problems need to be prioritised. Some decisions can be dealt with quite quickly and simply, leaving the really important decisions to be dealt with using something approaching the ideal of the systematic method described earlier.

Some investing decisions do not require an optimal solution. This can be because there is insufficient information to make the necessary fine distinctions in the rating process. In these cases, there may be several options, all of which may generally meet our objectives and in an inherently uncertain stock market, any of them will do. Nevertheless, this can be overdone. It is always useful to ask whether this idea is being pushed a little too far in the interests of speed, when quality of the decision is more important.

With simple and repetitive types of decisions, most skilled investors will employ heuristics or rules of thumb, which shortcut the process. It then depends on how skilled the investors are and how well their heuristics accord with reality. The use of heuristics in the hands of experienced and successful investors will often be very effective.

However, there is an important downside here. No matter how experienced we are, there will be times when the shortcuts let us down. This happens when we fall into one or more common mind traps well known in psychology or decision theory and being explored in the relatively new field of behavioural finance. The idea behind behavioural finance is to leave behind the simplifying assumptions of economics and study what people actually do in real world situations.

Every one of us suffers to some extent from a range of thinking biases that get in the way of making rational decisions. Nobody should feel guilty about this. Most people go through their entire lives without ever being conscious that they may be making these kinds of decision-making errors. The reasons that so many people do not realise the errors in thinking is because what they do seems so natural. The result is that successful investors often think quite differently about a range of issues in investing to the way beginners think.

By becoming aware of these biases and understanding them, it is possible to reduce the distortions they introduce and move our decisions closer to the systematic and rational model outlined earlier. There is no better antidote to these biases than studying them. My book Think Like the Great Investors explores many of the common errors and biases and does so in simple non-technical language. The ideas in the book can add to our decision-making skills not just in investing, but in all aspects of our lives. To buy a signed copy of the book, go to my web site www.bwts.com.au and click on the drop-down menu Buy Books.

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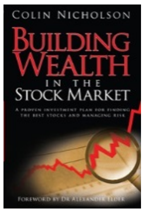

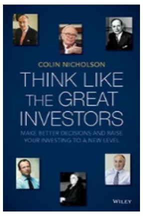

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