

Intuition-Good or Bad in Investing?

Our intuition often leads us well astray when it comes to investing. We often buy when we should be selling or focus on unimportant information. The findings of behavioural economics suggest that doing the right thing with our investments involves recognition of our biases and discipline. The work of Daniel Kahneman and his acolytes is particularly instructive. In professor Kahneman's book *Thinking Fast and Slow* opens up vistas on human behaviour that point toward our worst investing mistakes.

For a start, Kahneman asserts that it is a mistake to engage in day trading and think that you have an advantage in picking stocks. He suggests that investors do not always act in their own best interests and are often led astray by emotional motives and cognitive errors. Put simply, the average investor has little idea of the investing world. This leads to overconfidence and the making of poor investment decisions because of the overriding fear of loss. Investors often anchor to a target price for a stock that is arbitrary and irrational and end up holding the stock long after it should have been sold.

Thus, Kahneman eschews casting investors as rational beings who always act in their own best interests. Instead he casts them as normal people who chase biases that have little or no relation to statistical truth or the correct course to take. Thus our systems rely more on processing information rapidly and intuitively than in a more deliberate and analytical way.

One common emotional bias is called faulty framing: where we buy a stock which plummets. We hold off selling it because of the emotional stress of taking a loss. Because it is not a real loss until we sell it, we can hold it in a mental account where something still has hope even though the market has already decided otherwise.

Some other common errors:

- Misreading a short-term hot streak by a manager or company and thinking that it is indicative of a continuing success.
- Trusting gut instincts – intuitive insights are consistently unreliable – rely instead on outside views and distrusting our intuition.
- Reacting to outside events – typical here is the multi-faceted crisis scenario. There is simply too much information to process. We should make decisions one at a time with reference to our own goals. We should not spend too much time thinking of the wider aspects. We should instead think like a scientist – in other words employ critical thinking.

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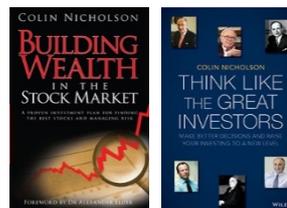
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