Overcoming Animal Instinct

Every investor seems to go through the same three-stage process of coming to understand the real nature of the task they are taking on:

First, comes the naive phase where we think that all we have to do is to analyse the market well and we will succeed. This leads to a study of fundamental analysis, technical analysis, or both. Some people never progress beyond this point and think that their failure to succeed is because they were not cut out to be good enough at analysis.

Second, comes the beginning of enlightenment as we begin to see that analysis is only part of the picture. Investing profits derive from the act of assuming risk. If there is no risk, then there is no profit opportunity. It therefore dawns on us that risk management and money management are just as important as analysis. Yet still we struggle to succeed.

Third, comes the completion of the puzzle, when we realise that people and markets are not entirely rational. Our mind is where the real battle takes place. The way we think is all-important to our success. We notice how good investors seem so calm and disciplined and yet we find investing can be both exciting and stressful. We realise that our thoughts and our emotions are the elements that complete the picture.

This three-stage process is really about discovering that investment takes place in three dimensions. However, there are many who never reach this stage and, more dangerously, some who seem to want to deny the existence of the third dimension. They do this because they do not want to take the risk of starting on the journey of self-discovery that is involved. They have come to the market as a way of avoiding problems that they have in dealing with the world. They soon discover that the market is like a heat-seeking missile; it homes in on those weaknesses.

That the greatest living investor, Warren Buffett, understands the importance of our emotions in investing should cause us to also pay attention. This is what he wrote in his famous Preface to Benjamin Graham's investment classic *The Intelligent Investor* -

To invest successfully over a lifetime does not require a stratospheric IQ, unusual insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.

This then is the shape of the problem; to master the market we have to learn to master ourselves. Investing involves what I like to call serial decision-making. Every piece of new information that comes to us causes us to make decisions, whether to buy, to sell or to do nothing. We make decisions using our mind and it is here that the battle is fought and won or lost, between investment success and failure.

The *Hutchinson Encyclopedia* 1995 Edition defines psychology as the *systematic study of human and animal behaviour. ……….The subject includes diverse areas of study and application, among them the roles of instinct, heredity, environment, and culture; the processes of sensation, perception, learning* *and memory; the bases of motivation and emotion; and the functioning of thought, intelligence and language.*

Most of us are aware that psychology is a relatively new field of scientific enquiry. Even more importantly, we will be aware of its problems, the biggest of which is that, unlike physics and chemistry, the systems being studied are extremely complex and difficult to measure in a precise way, such as we are accustomed to in the physical sciences. However, slowly more rigour and measurement is coming into the discipline as the principles of scientific method are applied to the issues.

Nevertheless, there exists today a body of knowledge that gives us valuable insights into the tasks of investing. We can often accept these ideas readily because they open up ideas and concepts of which we were not previously aware, but which ring true once we are exposed to them.

There are other ideas in psychology that are more challenging. These derive from the idea that it is what successful investors do that determines their results is often counter-intuitive – the opposite of what we do naturally in a given situation. Once we are exposed to the logic of the ideas we gain a better mental framework for dealing with the things that have previously hindered us in reaching our investment goals.

A good example of this is the trap many people fall into, concerns the idea of “the market’s money”. This is a really widespread idea that is not even recognised consciously by most investors. After every big bear market I invariably give a talk outlining how the application of simple ideas about what a trend is should always save us from being caught holding stocks that “crash and burn”.

The idea is that I put up a share price chart. I ask the audience to assume that they owned the stock. In most of the situations, there was a good uptrend leading into the first chart. From there, the chart begins gradually to deteriorate. The audience are to tell me when they would sell, as I show them how the price action unfolded.

One person commented about one situation that it “would depend upon the price that I paid for the stock”. This investor took the view that, if there was a good profit there and only part of it had been given back on the move down from the top, it was different to the situation where there was already a loss on the investment. In other words, if the investor was “playing with the market’s money” it was somehow different to where the loss was of the person’s “own money”.

Now, this is a good example where there is more than one way of looking at a situation. The novice investor looks at it as I have just described. The successful investor looks at it entirely differently. Both would agree that the investment task is to utilise money in their investment account to make profits. One way to do this is by buying a share at one price and selling it at a higher price.

Let us say that Cathy and Simon both buy a stock at $1.00. It rises to $2.00. At that point we ask them both what their profit is. Both say that it is $1.00.

Cathy sells at $2.00. Tom waits a while and the price goes down. He sells at $1.80. We ask them again what their profit is. Cathy says $1.00 and Tom says 80c.

We put it to Tom that from when we asked him the first time, he lost 20c. “No”, he says, “I didn’t lose anything, it was only the market’s money.” He cannot see that he is redefining his profit from when we first asked him. And why is he doing this - to protect his ego perhaps?

To see the point, consider that he had bought the stock at $2.00 instead. When it went down to $1.80, he sold it at a loss. He would then agree that he had lost 20c. However, the situations are exactly the same – he did own it at $2.00 in the first situation and he sold it at $1.80.

The psychological insight here is that we need to understand the many subtle ways in which we sabotage our investment results in order to protect our ego. We do this by looking at reality in a way that protects our ego rather than maximises our profits. The successful investor is the one who knows that paper profits are theirs, just as much as are realised profits and should be protected in the same way.

This reminds me of a story I read somewhere many years ago about an investor who, when he made a big profit, forced himself to put it in his bank account and not invest it again – until he had got used to owning it! The same point is being made – that the money is his, but there is a temptation, just as for the gambler in the casino, to take less care and greater risks with “the casino’s money”.

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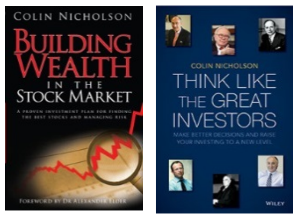

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