Randomness

One of the reasons for learning more about how we think is so that we can bring our ideas into closer alignment with reality. The extent to which we succeed as investors will depend in large part on whether what we are trying to do, and the results that we seek, are realistic. The problem is that reality is very elusive. We all see the world through the prism of who we are – what we know, what we believe, our temperament, our attitudes and our experiences.

Everyone will have had the experience of seeing different people interpret the same facts in totally opposite ways. Since every one of us sees the world differently to everyone else, we can rarely be certain whether it us, or them, or neither, who are seeing things properly. Over a long time, mankind has developed rational ways of thinking and of proving what is true and what is not, known as the scientific method. The facts are examined and a hypothesis developed. Then the hypothesis is tested on data other than that on which it was developed. Another person should be able to repeat our tests and get the same result.

A useful way to think about this is that a hypothesis is simply a belief about how the world is. It remains a belief until it is proven. As Philip K Dick put it:

Reality is that which, when you stop believing in it, doesn't go away.

In investing, as in the rest of life, we develop our beliefs from observation. However, humans are very poor observers. This is because we have great difficulty in dealing with randomness. In a nutshell, we have an incredibly strong tendency to see patterns and meaning in random behaviour. Think how many times you, or others, have seen pictures in clouds. Chartists and technical analysis are justifiably accused of this failing by those of the other faith – fundamental analysis. Yet they too see their own patterns in the data or have unsupportable beliefs about their craft.

There are several reasons why we have a strong tendency to see patterns in randomness. Possibly the strongest of them is that most of us want very badly to believe that there is an explanation for everything. We have great reluctance to believe that something can happen for no obvious or logical reason. For example, short-term movements in prices of stocks are often to a large extent quite random and unpredictable. Yet every day in the newspaper we read a reason for significant price changes. This is because a journalist is charged with explaining the movement. He or she begins with the assumption that the change in prices has a logical explanation based on cause and effect. So the journalist looks around for a reason and will always find one. Say the market was down yesterday and interest rates were increased that morning, the story will be that higher interest rates will reduce profits and this caused the fall. Now suppose the market was up yesterday. Then the story might be that the increase in interest rates shows that the Reserve Bank is keeping the economy from overheating and as this is good for business, it explains the rise. All that has happened here is that the journalist has linked two events by a logical explanation, which may or may not have anything to do with why prices changed on the day. It may be one reason among many and not even the most important reason.

In the example just given, it is easy to accept that both the explanations are logical and complete. A great number of people accept what is written without questioning it. Indeed, it is difficult to prove such explanations because there are so many shifting variables with shifting leads and lags in the complex system that is a modern economy. It may just be that for myriad reasons, particular to each market participant, there was more supply on the day prices fell and more demand on the day prices rose. This could have changed if one large buyer was late back from lunch on the day prices fell and did not put his or her order into the market until the next day.

We need to be very careful that we are not seeing patterns of behaviour or logical reasons that suggest something that is simply not there in a random situation. As Ralph Hodgson put it:

Some things have to be believed to be seen.

This raises the question of what we should do about this problem so that we become better investors.

I am reminded of the investor who has read a positive analysis of a stock. Any analyst worth their salt should have presented both positive and negative factors affecting the stock. However, that is not how the investment world works most of the time. Instead of a balanced view, most analyst recommendations will stress only the positive factors. After all, a broker analyst is a sales person and a good marketer does not muddy their sales story with negative views. So, our investor sees the stock as a sure fire winner and hastens to buy it. The investor is seeing only a positive view of the stock and is certain it is a buy. We may then ask: Why, if it is a certain winner, would anyone sell it? Clearly, there must be either a different view of the stock, or the seller has a motivation that is unrelated to future price action. If there is a different view, our investor will be well served to work out what those negative reasons are. If our investor cannot discover them, he or she should seek out someone who can be their "devil's advocate" and suggest reasons why the stock may not rise in price. Once those reasons are found, and only then, can the investor weigh up the pros and cons and make a sound decision.

This is the exact opposite to what most people do: They seek only assurance and agreement from their peers. This is very dangerous. While they should value highly those who agree with them, the most valuable friends they have are those who question what they think and test them with different views or facts of which they are not aware.

No matter what decision we have to make in investing, one of the most powerful tools is a single sheet of paper with a line down the centre. On the left we should write down all the pros. On the right we should write down all the cons. If one side has no points we can think of, we need to seek them out through research or by consulting knowledgeable people.

Remember though, that the pros and cons will often be opinions rather than facts. It is important to test each opinion, our own or those of others, by facts that support the opinions if at all possible. This is a very powerful process to go through. It takes time, but investing involves significant sums of money, which will to some extent affect the rest of our lives. Many people spend a lot of time weighing up which restaurant to go to, but make investment decisions involving tens of thousands of dollars on the basis of one biased opinion they have heard or read somewhere and have not questioned in any way.

The best investors are sceptics. They question everything before taking it on board. They use a technique known as "contrary thinking". What this means is that they look for the contrary argument in any situation. Once we adopt this stance in our investing, we will become far better decision makers and will be more likely to join the ranks of the best investors.

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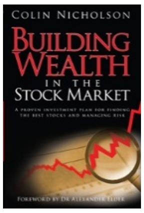

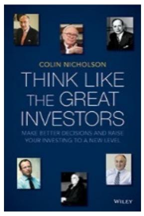

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