Seven Deadly Sins: Why Emotions make us Poor Investors

There are some basic pre-requisites for new investors, before they venture into the market with their hard-earned savings.

New investors should realise that they are playing a serious game in someone else's profession. The investors on the other side of their buy and sell orders are likely to be highly intelligent, highly trained and very experienced. They also work very hard at what they do. To have any chance of succeeding, new investors should take the time to educate themselves, learning how the stock market works, how to carry out basic security analysis and how to read a price chart.

New investors should also appreciate that knowing the theory is one thing, but to be an effective investor, they also need experience. It is best to start slowly, buying one share at a time with a small part of their capital, until they have developed a successful track record. Only then should they take more of their capital away from professional fund managers to manage it themselves.

Of course, many people believe investing is easy and can be learned as they go along. They try to avoid the costs of training and the time needed to gain experience and simply go in boots and all. The sad fact is that most of them will then find out the hard way that their teacher is the market. The market charges high fees for tuition, called losses.

It generally takes about ten years to learn to be an effective investor. This time tallies with how long it takes to become competent in most professions of a similar nature.

By this point, new investors should have a written investment plan, have developed their analysis skills and know how to apply sound money management. They might now settle back to manage their portfolios. However, if they really want to improve their investing skills and try to join the top investment performers, there is one more skill they need to develop. They need to learn how to make sound decisions.

The greatest investor of our times, Warren Buffett understood this critical issue right from the start. In his famous preface to what he described as the best investment book ever written, Benjamin Graham's The Intelligent Investor, he said that "what's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework".

This is an absolutely critical skill for investors to have. We all think that we always make logical and rational decisions. However, this is not true. Every one of us is human and we have been brought up to have very human weaknesses in the way we make decisions. In a nutshell, we are not always rational maximisers. We are highly emotional decision-makers. To the extent that we use logical thinking, it is often simply to rationalise a decision which we have already made unconsciously based on our feelings.

In the last few decades, economists have begun to question the assumption underlying their theories. This was that we will always make decisions that afford us our best advantage. A new field called Behavioural Finance has sprung up and already yielded a couple of Nobel Prize winners. What this new cohort of economists and psychologists has done is to look at how we really make decisions. Out of their work some clues have emerged as to what mistakes we make.

This leads logically to a better understanding of how to avoid the errors and biases which we have unconsciously learned as we have grown up. One of the interesting things is that Warren Buffett is a great investor, because he is better than most of us at avoiding these mind traps.

The first step in trying to overcome these natural biases and errors in the way we make decisions is to be aware of them and become conscious of them in ourselves and in our advisers. The next step follows, which is to develop some strategies for overcoming them and hopefully improving the decisions we make.

The problems which investors need to deal with may be seen as the seven deadly sins of investing:

Deadly Sin #1: Greed

The worst thing to happen to new investors is to make a big profit on their first investment. It will make them think investing is easy and all they need to do is find a similar stock.

However, the profit on their first investment may have had nothing to do with any factors which are within the control of these “first time lucky” investors. The risk is that any similarities between the two stocks are actually irrelevant.

One way to deal with this very real temptation is to have a written investment plan, which you have thoroughly tested over many stocks in different market conditions. This plan should have a list of criteria, which every prospective investment must satisfy before you buy. Write down your assessment on each point, including your reasons for believing your judgement is correct.

Assuming the new stock passes that test, next consult someone who is knowledgeable about share investing and who is not themselves involved with that stock or with the consequences of your decision. Ask them to play devil’s advocate and test your decision. Specifically, ask them to suggest why someone would sell the stock to you.

If the investment still stands up after that test, the final step is to sleep on the decision before you act on it. A day or more will make no difference in the end, if it is a sound investment. If you are still sure of your decision in the cold light of morning, then make your investment.

Deadly Sin #2: Fear

Inexperienced investors invariably fear events which are very unlikely to occur. Many of them have vivid personal recollections of the 1987 crash on the Australian market. The one-day fall in October 1987 is by far the largest fall on a single day on our market, or on any of the stock markets in the developed world. However, it occurred in October and many investors now have a fear of that month that a similar crash is likely to happen again as each October comes around.

This fear is driven in large part by how dramatic it was. Many of us remember it from our personal experience, which has been periodically renewed by vivid and sensational accounts in the media. This is known as availability bias and is very common in all aspects of our lives. The reality is that statistically October has been a very average month on our stock market over the past 80 years.

If you want to insulate yourself from irrational levels of fear, try to stay away from the crowd, which includes the media. Write down in unemotional language what your fear is. Having defined it, then seek out the factual data to determine what the probabilities are of the event you fear. A crash like October 1987 has occurred only once in 107 years. Therefore, is it something you should fear next year? When everyone thinks October is dangerous, your realistic assessment may give you a real advantage.

Deadly Sin #3: Regret

Regret occurs in many guises in investing. One of the most pernicious is when investors indulge in what is called counterfactual thinking. No matter how well or how badly an investment turned out, there is always the opportunity to imagine a scenario that might have turned out better.

This leads to a regret statement beginning “If only I had not made the decision I did …” The worst of all outcomes from this is that you are paralysed instead of acting in a dangerous situation, or you give in to inertia when the situation is very uncertain, in case you make a mistake.

A powerful learning tool here is a detailed investing diary. As well as writing down why you bought a stock, record all the stocks you considered and did not buy, with reasons for your decisions. Paste in print-outs of all the information you used to make your decisions.

Then, when you feel regret later, you can turn back and see accurately and undistorted by hindsight, exactly what you did and did not know at the time. Next, ask why you now regret your investment decision. Look for documented evidence, which was available at the time, of what caused the worse than expected outcome. Could you have foreseen what happened? Then repeat the process for the ones you did not buy, but performed better than you expected. Was there documented evidence at the time that you overlooked? If you could not have reasonably foreseen either outcome, there is nothing to regret. If there was, you will have learned from the experience.

Deadly Sin #4 Overconfidence

Overconfidence is the result of a mixture made up of very human foibles. We all tend to believe our skills are better than the average. The less we know about a subject and the more difficult the decision, the more overconfident we are.

This is combined with the general reluctance we all exhibit to admit we are wrong, or that we do not know something.
Finally, we stir in the tendency to feel that the future is more predictable, just because we are on a hot streak. In the stock market, we now have a poisonous mixture. Luckily, there is an antidote which comes as two courses of treatment.

The first treatment is to reframe our investment decisions into two groups. The largest group will be the stocks where there is great uncertainty or insufficient information. This is the “too hard” pile. The smaller group will be the few stocks which tick every box on our investment selection checklist. This is the “to do” list. This is a powerful treatment because we have now avoided the issue of having to admit we did not know something. We have simply reframed all the tough decisions as just too difficult. Nevertheless, for some investor patients this treatment is unsuitable.

The second treatment is to base their investment plan on the assumption that they are overconfident and cannot be trusted in the swirl of emotions in the market. The worst cases are strapped into a straight-jacket called an index fund. The milder cases are given a dose of diversification elixir which compels them to spread their risks and keep rebalancing them.

Deadly Sin #5: Surprise

One of the most difficult things for beginners to understand in investing is that nothing is certain or predictable. They flock year after year to hear the predictions of gurus. These gurus tend to sing the same tune and soon everyone is singing it in their investing.

Experience has shown that the more certain everyone is that they know what will happen the more likely it is that something will surprise them. Also, the longer the good run by a market or a stock, the more savage the eventual correction to reality.

The crowd is always wrong at the critical points in the market. A long-established technique for dealing with a crowd stampede is to step out of the way and try to imagine alternative scenarios. This is known as contrary thinking. Become a sceptic and question everything. Look for the reasons for and against a view. Ask if there is any other possible view and critically examine it. Pay special attention to any guru singing a different song.

Rehearsal is another powerful technique which is well known in the military. To adapt it to investing, list all the possible ways the enemy (the market) could surprise you. The more unlikely you think the event may be the better, because the unexpected is always more difficult to deal with. Take each possibility and imagine what it might be like. Having put yourself in the situation in your imagination the next step is to rehearse mentally the way you should deal with it.

Deadly Sin #6: Risk

New investors often fall for the glib assertion that we all have a level of tolerance for risk. Reality is that our tolerance for risk is dependent on our mood, which will be influenced by recent experiences. Our tolerance for risk is also different to our tolerance for profits, although many investors unconsciously think of them as the same thing.

One of the oldest rules of investing is to let profits build and cut losses quickly. However, a loss and a profit of the same magnitude do not have the same intensity for most investors. They tend to lock in small profits to avoid losing them, but avoid taking small certain losses on the chance that things may turn around.

Interestingly, the less money investors have, the more likely they are to take greater risks.

One of the strongest strategies for dealing with risk is to frame it correctly. Say that your portfolio is worth $100,000. You put $2,000 into one company and it goes belly up, losing the lot. Framing it that way you feel very badly about it. However, if you frame it like this: One of your investments fails and you lose 2% of your capital. This is more realistic and much less painful.

The keys are to never put too much of your money into any one stock and to have consciously considered and accepted the worst loss you might make set against the best gain you hope for.

Deadly Sin #7: Prediction

One of the natural human traits which is most destructive to investing success is the belief in our ability to control events and to predict the future. Some of this is due to hindsight bias, where we assume we knew more at the time than we did, because what we know now is colouring our recall. A nasty tendency is for us to see something happen a few times recently and assume that is an indicator of a long term trend. Although we dispassionately accept that large samples of data are better indicators, we often reach conclusions on small samples.

This is a reflection of our tendency to seek patterns even in what we know is random data. We are uncomfortable about, and unconsciously reject, the idea that much of the world may be random.

A very strong tactic to counter our unconscious pattern-seeking behaviour is to make it part of our conscious analysis to determine the base rate. The base rate is what we would expect from a large sample of data. Just because a few new floats are very successful is not enough. Seek out how the average float has turned out over the last ten years. The result may even be a negative one.

Another skill to develop is to question whether two things are simply correlated. Seek clear evidence of cause and effect, before you assume you are looking at anything more than coincidence. Remember that if you search the data hard enough, you can always find a correlation, but that proves nothing.

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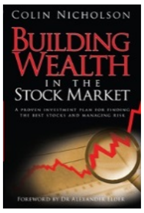

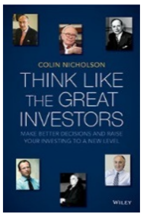

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