THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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By Nimesh Chandan

The mind sees what it chooses to see…

"It is a capital mistake to theorize before one has data. Invariably you end up twisting facts to suit theories instead of theories to suit facts"

- Sherlock Holmes, (Arthur Conan Doyle), A scandal in Bohemia.

In Greek mythology, one comes across a bandit character named *Procrustes* who lived on *The Sacred Way* between Athens and Eleusis. *Procrustes* used to invite tired travelers to his home, give them food and offer them his bed to rest. However, if the travelers were short and did not fit the bed completely, he would hammer and stretch them. If the travelers were tall, *Procrustes* would amputate the excess length. In either case, the travelers died.

We actively seek out only the information that supports our beliefs or actions and ignore or undermine the information that is contradictory

This story of the *Procrustean Bed* is used to describe how people try to fit facts into a preconceived theory. Researchers have shown that we actively seek out only the information that supports our beliefs or actions and ignore or undermine the information that is contradictory. This tendency affects investment decisions too. It comes in the form of two characteristics of our behavior - **Confirmation Bias** and **Cognitive Dissonance.**

CONFIRMATION BIAS

Once we make an investment, we actively search for reassurance and confirmation for our actions. We love meeting people who have something good to say about it. This may include other like-minded investors, analysts recommending this particular stock/asset, owners or management of the company (who generally are optimistic about their prospects) etc. We also start noticing every small positive development, no matter how insignificant to our case. New information is also viewed under the lens of existing convictions. This is Confirmation Bias. Confirmation bias may lead to over confidence

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and negligence of BUY-SELL discipline (know more from our previous issue). Investors who only look for a positive news about their investments are vulnerable to high portfolio concentration or even high leverage. They may miss spotting a change in the business trend or in identifying a mistake in their forecasts. The result? - Bad investment outcomes.

How do you counter the confirmation bias?

The antidote to confirmation bias was discovered way back in the 16th Century. During a **canonization process** *(an act by which a Christian Church declares a person as Saint)* employed by the Roman Catholic Church, a person is assigned to argue against it. It was this person's job to take a skeptical view of the candidate's character and to look for holes in the evidence. The position of this person was known as **"Advocatus Diaboli"** or commonly referred to as **"The Devil's Advocate"**.

Knowledge about the downside risks to the investment does not make the investment case weak, in fact it makes it stronger

Confirmation bias can be managed by having a team member or a friend play the devil's advocate against the investment decision. We must make sure the person is someone we trust and would act in our best interest. The decision maker also must be mentally prepared to accept the negative findings. So, one must understand that knowledge about the downside risks to the investment does not make the investment case weak, in fact it makes it stronger.

COGNITIVE DISSONANCE

When the new information conflicts with our pre-existing beliefs and decisions, we experience a mental discomfort called the cognitive dissonance. This condition is also known as psychological scotoma - When people are faced with information that is inconvenient to their ego, they respond by turning a 'blind eye' to it.

After making an investment, if there is a negative development reported in the company or some other stock comes in as a better investment, we have a hard time accepting the new reality. Our mind struggles to rationalize the conflicting information to alleviate this discomfort. Investors can go to great lengths to justify their decisions. One of the biggest and the most dangerous rationalization statement in financial markets is "this time it's different".

As a result of cognitive dissonance, investors either add to their loss-making investments or continue to hold them as they sink. Many investors also mentally assign the loss to luck or a third party to relieve themselves of the pain. By not accepting their mistake, these investors make themselves vulnerable to repeat them.

How to avoid the pitfalls of cognitive dissonance?

Expecting mistakes, accepting mistakes and learning from mistakes are the way out of this dissonance. Investing is simple not easy; hence expect mistakes. Before making an investment, investors must go through a pre-mortem analysis. If you are buying a stock, imagine that two years hence, (or at the end of your investment horizon) the stock has given a negative return. List down all the things that you think that could have led to such a poor return. It is important to do this exercise before taking the action to remain unbiased. Perform a scenario analysis, giving a base case, bear case and bull case with probabilities of these cases coming true. These tools will help the mind expect and accept the mistakes.

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Maintain an investment journal where you record every investment decision. When evaluating the outcomes, compare them with your journal and check what worked and what did not. Use your experiences (especially your mistakes) to make an investment checklist. Before making the next investment, refer to the checklist and ensure you are not repeating a previous mistake.

Back to *Procrustes*!

Procrustes continued his reign of terror until he was captured and killed by *Theseus*, a Greek hero of Athens. The name *Theseus* comes from the Greek word "*Thesmos*" which means rule or precept. Taking inspiration from Greek mythology, investors can also use these rules or precepts (like Devil's Advocate, Pre-mortem, Scenario Analysis, Investment journal and Investment checklist) to overcome **Confirmation Bias** and **Cognitive Dissonance.**

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Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind'.

ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).