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## *Taking a decision with your eyes closed!*

*"The situation has provided a cue; this cue has given the expert access to information stored in memory, and the information provides the answer. Intuition is nothing more and nothing less than recognition."*

- Herbert Simon

You probably haven't heard the name 'Stanislav Petrov'. And maybe you will find it hard to believe that he saved the world from a nuclear war! Well, he actually did. Lt. Col. Stanislav Petrov was a Soviet army officer, stationed as duty officer at Serpukhov-15 (the secret bunker outside Moscow) monitoring the nuclear early-warning satellite system. His job was to report any threat to the higher command so that a retaliatory action can be taken in time. On September 26, 1983, the system detected five incoming missiles from the United States. The sirens howled and the big screen in front of him lit up with the word 'Launch' flashing on it. The instructions were clear: he had to pick up the phone and report the attack to the military and political leadership. They would, no doubt, respond with their own missile launch.

Every minute of delay took away valuable response time. But Petrov froze. "I had a funny feeling in my gut", he recalled in an interview later. Something told him this was a false alarm. He rechecked the details; the system was clear about the incoming missiles. But Petrov wondered, 'why would US launch an attack now?', 'why would they launch only 5 missiles?' It didn't make sense as five would hardly damage Soviet capabilities and they would surely retaliate with a much severe attack on the US. Petrov called the command and reported a system malfunction. He was right! On investigation, it was revealed



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that the system mistook a reflection of a certain cloud formation as a missile attack. If Petrov had not trusted his intuition, the world would have been very different today.

## INTUITION

Psychologists say our thinking is divided into two levels – system 1 which is spontaneous and automatic; and system 2 which is slow and deliberate. When something is thrown at you, you duck – that's system 1. When you are asked to multiply 19 and 27 – you are using system 2. Intuitive judgements are quick and almost effortless, and hence form a part of the system 1. When you call your spouse on the phone, your intuition gives you an idea about what mood he/she is in. Experts like chess masters, doctors, firefighters can quickly get a sense of the situation and prepare to react. That's expert intuition. We will be concentrating on expert intuition in this article.

Herbert Simon, economist and cognitive psychologist, defines intuition as recognition of patterns (Quote above). This also sets the underlying conditions for effective and useful intuitions. a. There has to be an environment which is sufficiently regular and repeating. b) there has to be an opportunity to learn these patterns through prolonged practice. (you are thinking about the call with your spouse, aren't you?). With the help of a few more elements, let's try to put this in a story: an activity is practiced regularly using well thought process of system 2 thinking. There is clear feedback and it is analyzed to develop a model. With enough experience and learning, one becomes skillful at it. The development of this skill transfers the activity from system 2 to system 1. With enough skills in an area of work, where outcomes maybe uncertain but the patterns are 'regular', one develops expertise. When confronted with a new situation, the expert now can decipher signals (cues) from the noise and act with expert intuition.

I am not a psychologist, but that story sounds right to me intuitively 😊

## INTUITION IN INVESTING?

George Soros once confessed to using his instincts in decision making. "I very often used to get backaches due to the fact that I was wrong.

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Whenever you are wrong you have to fight or [take] flight. When [I] make the decision, the backache goes away.” A lot of investors use their intuition in making decisions. For traders, it may be used to separate the relevant signal from the plethora of information that gets bombarded on them. Many traders are good at using price signals to trade, but they often can’t explain really what the logic behind it is. For fundamental investors, intuition can be about judging the business potential of a product/service, management quality or valuation range. Quite often intuition plays a role when investors select their financial advisor or a portfolio manager.

Even when decisions are taken based on instincts, the system 2 is deployed to create justification and rationale. This is a source of confirmation bias. I believe intuition gets highlighted as one of the inputs when decisions lead to success. Hardly anyone would want a wrong judgement call to be highlighted.

### **CAN WE TRAIN OUR INTUITION?**

Human nature causes stock markets to have deep cycles (I wrote about it [here](#)). This provides an environment where expert intuition can be useful. But how do we train ourselves better to take advantage of it?

The system 1 reacts quickly and automatically. If the intuition is not based on skills and expertise, the brain will use heuristics (or rules of thumbs or biases) to make decisions. To make the best judgements, there are hence two target areas to work on: a) develop expertise and b) reduce impact of biases.

- **Develop Expertise:** As mentioned earlier, experience is not equal to expertise especially for good intuitive judgements. There has to be a mechanism to collect timely feedback and analyze the results to understand patterns. Learning financial history helps understand the range of outcomes possible. Also, whenever you encounter surprise, use the opportunity to learn and add the incident to your arsenal. I have, in previous articles, mentioned the use of investment checklists and investment journals as tools that can help in this area.



**Rather than immediately forming an impression about an investment or a portfolio manager or an advisor, collect and score the relevant information separately first**

- **Reduce the impact of biases:** When there is lack of sufficient expertise, you become more vulnerable to make mistakes in your hot state when system 1 is acting. It is better to stick to an algorithm or process to make decisions (Read [here](#)). Or, you can look for a coach to help with the initial set of decisions.

## **THE BEST IDEA I FOUND – DELAYED INTUITION**

To me, the best way to effectively use intuition as an input in decision making, came in the form of an incident narrated by Daniel Kahneman. In 1955, Kahneman was assigned to improve the interview system for the Israeli Defense Forces. There was already an interview method to evaluate whether the candidate was fit for combat duty and which department of the army was the candidate to be assigned to. Change was required as the interview process was found lacking in correctly predicting the candidate's future performance. Kahneman concluded that, one of the reasons the process failed was that the interviewers delved too deep into the dynamics of interviewees' mental life and did not focus on gathering specific information required for predicting candidate's performance.

He changed the method of interviews to first collect information about several relevant personality traits of the candidate and score them separately. Then at the end, the interviewers were instructed to "close your eyes, try to imagine the recruit as a soldier and assign him a score on scale of 1 to 5". After several interviews, when the results were evaluated there was sharp improvement. The intuitive judgement that the interviewers summoned up in the "close your eyes" exercise also did very well. In Kahneman's words, he learnt that "intuition adds value in selection interview, but only after a disciplined collection of objective information and disciplined scoring of separate traits".

Investors can also use this technique of delayed intuition. Rather than immediately forming an impression about an investment or a portfolio manager or an advisor, collect and score the relevant information separately first. When you have short listed the top few that fit your important criteria, then close your eyes and let your intuition select the one. This combination of process and intuition can really deliver the best of system 1 and system 2 thinking. I really 'feel' so 😊

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**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).*

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