THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

December 08, 2020, Issue #44

By Nimesh Chandan

Looking back from an imagined future!!

"Several things go together for those who view the world as an uncertain place: Healthy respect for risk; awareness that we don't know what the future holds; an understanding that the best we can do is view the future as a probability distribution and invest accordingly; insistence on defensive investing; and emphasis on avoiding pitfalls. To me, that is what thoughtful investing is all about"

– Howard Marks

Very few battles in history can match the significance and the impact of the Battle of Cannae, that was fought between the Romans and the Carthaginians in 216 BC. The Carthaginian General, Hannibal, invaded Italy and through his genius tactics, inflicted casualties of as high as 50,000 in two battles (at Trebia and at Lake Trasimene) against the Romans. The Romans, with an aim to crush Hannibal once and for all, decided to put together 86,000 troops - the largest army in the republic's history. The command was given to two Consuls (powerful Generals), Lucius Aemilius Paullus and Gaius Terentius Varro. Typically, each consul will have command over his segment of the army. However, this time, since the legions were combined, Paullus and Varro were supposed to alternate the command on a daily basis.

The showdown was supposed to happen at Cannae, a town in southern Italy, where Hannibal had captured a vital Roman supply depot. The Romans greatly outnumbered the 50,000 strong Carthaginians army, but were comparatively weak in cavalry. The two Consuls had disagreements about when and where to engage Hannibal. Paullus wanted to take more time to decide but Varro was keen to engage. Varro was confident their strong army could take on Hannibal in any location. Since the command changed on a daily basis, the moment Varro got the opportunity, he took the army down to the battlefield. Hannibal had anticipated this. He had positioned the army in a way

A premortem is simply a method for identifying potential flaws in a plan. It works by having the team imagine that the plan has failed and identify the reasons for its assumed failure

that dusty winds and sunlight would disturb the incoming enemy attack. He strategically placed his army in a crescent formation intended to slowdown the enemy march in the center. Two columns of infantry were kept hidden on either side to envelope the enemy from the sides. The Carthaginian cavalry used the flat grounds on the riverbank to defeat the Roman cavalry from the side and then attack the Roman infantry from behind.

Knowing what can go wrong with the investment and being prepared for it, strengthens the investment thesis

The Romans, unprepared and surprised, were surrounded by the enemy in a space so tight, it restricted their movements. Approximately 70,000 soldiers were slaughtered and 10,000 captured. A loss that shook the Roman republic. This loss, this scenario, could it have been anticipated and hence avoided? Does this incident show overconfidence, impatience, lack of sufficient information on part of the Romans and problem in their decision making (command) structure?

PREMORTEM

We are aware of a process called "Postmortem", where the medical examiner determines the cause of death. It is also used as a term to describe the post facto analysis of a failure of a project or an investment. The Romans conducted such analysis post the defeat at Cannae. But is there a way one can identify the problems in a plan before it is executed? Can there be a method to anticipate the potential troubles one can run into and take steps to eliminate them or at least prepare for them? Leading psychologist Gary Klein has popularized a method called the Premortem, which does exactly that. "A premortem is simply a method for identifying potential flaws in a plan. It works by having the team imagine that the plan has failed and identify the reasons for its assumed failure", says Gary.

It's a bit like travelling to an imaginary future. Imagine you are in December 2022 and the investment decision you took in December 2020 has led to a loss. Now, write down all the reasons which could have led to this loss. This method is also known as Prospective Hindsight, as you are imagining going to a future date (prospective) and looking back (hindsight) at the present to evaluate a decision. This method of decision analysis is endorsed by Nobel Laureates, Danial Kahnemann and Richard Thaler.

Backcasting can help identify what are the trends, outcomes, characteristics etc. that are important for the investment to perform well and deliver good returns

Doing a premortem of an investment helps:

- Understand any weaknesses in the investment thesis before it is implemented. It highlights areas and developments to watch out for.
- Reduce overconfidence. According to Gary Klein, "There is ample evidence that most planners, team leaders, and teams in general, are overconfident. The premortem challenges the team's hubris by acknowledging that things can (and will) go horribly wrong".
- When conducted within teams, it promotes a culture of openness and candor. Team members are encouraged to voice their concerns rather than get attacked for their dissent.

A premortem, when properly done, can improve the chances of success by laying out things to watch out for. Knowing what can go wrong with the investment and being prepared for it, strengthens the investment thesis.

BACKCASTING (BECAUSE IN INVESTING, WE NEED THE OPPOSITE TOO!)

Backcasting is an analysis that starts with defining a desirable future and then work backwards to identify steps that will connect that specified future to the present. It can be viewed as a premortem from success point of view rather than failure. Imagine that you are in December 2022, the investment you made in December of 2020 is a huge success. Now write down what could have been the developments that led to such good returns.

Backcasting can help identify what are the trends, outcomes, characteristics etc. that are important for the investment to perform well and deliver good returns. The combination of Backcasting and Premortem can give a range of monitorables which are important in the success of the investment. It is possible that many variables are common but just envisioned in different scenarios. Typically, thinking positive about our decisions is easier for us than thinking negative. Annie Duke in her book, 'Thinking in Bets' writes "Imagining both positive and negative futures help us build a more realistic vision of the future, allowing us to plan and prepare for a wider variety of challenges".

The analysis of possible future scenarios can give the investors, a range of intrinsic values for a security or an asset

COMBINING INTO BULL BEAR BASE CASE SCENARIOS

Beautifully put by Howard Marks in the quote presented at the opening of this article, investors have to deal with an uncertain future and have a healthy respect for risk. The analysis of possible future scenarios can give the investors, a range of intrinsic values for a security or an asset. These can be summarized into three values: A bull case value, a bear case value and a base case value. By understanding the drivers and assumptions behind these scenarios, one can even assign a probability distribution to them. Such analysis of different target prices along with their subjective probabilities will help better investment decisions:

- These values will help understand the risks (both of downside and upside) to the investments made
- Set pre-commitments of actions to be taken when a particular scenario is triggered
- Help better allocation of capital by identifying potential low-risk and high-return investments
- Reduce biases like overconfidence, confirmation bias and cognitive dissonance

It is important to conduct the scenario analysis before the investment is made. Once the allocation is committed, the investors may suffer from endowment effect and may dilute the bear case scenario or strengthen the bull case. After the initial exercise as events unfold, and with passage of time, the scenarios need to be updated. But it is important to keep track of the changes being made to evaluate them during investment reviews. Scenario analysis can be made part of the investment checklist to implement the process with discipline. Also, using scenario analysis along with the investment journal can help in identifying biases and improve the decision-making process.

Investors need to accept and adapt to uncertainty. One of the powerful and simple ways of doing so is building the scenarios and preparing for them.

CANARA ROBECO
Mutual Fund

NIMESH CHANDAN

HEAD – INVESTMENTS, EQUITIES

CANARA ROBECO

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).