THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

April 10, 2020, Issue #13

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MISSING THE FOREST FOR THE TREES!

Daniel Atlas (The Magician): *Do you see your card here?*
Participant: *No*
Daniel Atlas: *That's because you're looking too closely. And what have I been telling you all night? The closer you look... the less you see!*

– From the movie "Now you see me"

One realizes that each object in the painting (the man, the wall and the clouds) could also be hiding something behind itself! Yet, for most, the mind initially focused only on the face. It grabbed the attention because the face is the only thing which is 'visibly hidden'

One of my favorite paintings is "The Son of Man" by Belgian surrealist painter, Rene Magritte. The beauty of this painting lies in the curiosity it creates among the viewers to decode the artist's message. The picture of the painting is provided below. Let's see what you make of it.

At first glance, most people would naturally be curious about the face that is hidden by the apple. One can see the face partially but it's still quite difficult to identify the man. You will also have some thoughts about why the face is partially covered, what does the apple signify

etc. Is that the gist of the painting or does it convey anything more about the human nature? Let's step back and take a broader view. Now, one realizes that each object in the painting (the man, the wall and the clouds) could also be hiding something behind itself! Yet, for most people, the mind initially focused only on the face. It grabbed the attention because the face is the only thing which is 'visibly hidden'.

Whenever I look at this picture, I think about the psychology of attention and how important it is in the field of investing. Something akin to the picture happens in investments too where one misses the forest for the trees. Investors often focus on the high frequency short term data and miss out on the long-term themes or trends.

COST OF DISTRACTION

Noise does take focus away from long term investing and leads to shrinkage of investment horizons

"Don't watch the market closely... if they (investors) are trying to buy and sell stocks and worry when they go down a little bit - and think they should maybe sell them when they go up - they're not going to have very good results".

– Warren Buffett

Attention is scarce and there is enough noise in the financial markets to keep investors distracted from their core investment process. Here I use 'noise' as representative of data / news flow / small events which ideally should not have a significant impact on the investor's decision-making process (unlike information). However, noise does take focus away from long term investing and leads to shrinkage of investment horizons. Noise creates excitement and anxiety; and induces participants to trade more. Investors tend to fall into cognitive traps and swing with the crowd thereby compromising their investment returns. The important behavioral mistakes that creep into our decision making during such times are:

- **Law of small numbers:**
  This is a cognitive mistake in which people exaggerate how closely a small sample will resemble the parent population from which the sample is drawn. They generalize or conclude a change in a

characteristic of the entire population (industry) based on the change observed in a small subset (companies) of that population (industry). People can make error in generalization in two ways –

- **Gamblers Fallacy:** Imagine a coin is flipped three times and each time the coin lands on heads. If you were to bet on the outcome of the next flip. Would you bet heads? Or tails? Ideally you should be indifferent as each coin toss is an independent event. A fair coin will tend to deliver heads and tails in the ratio close to 50:50 over a very large number of outcomes. Expecting mean reversion in a small set of tosses is an error called gamblers fallacy. In stock market, after a short upmove, many investors pronounce that "Since the market has gone up x days in a row, it should correct the next trading session hence one should stop buying/ start selling". This is a common example of investors trying to estimate short term mean reversion.

- **Hot Hand Fallacy:** This theory draws inspiration from the belief among basketball fans where it is possible that if a player scores a few baskets he is supposed to be on a streak (have hot hands) for that game. Players are thought of as having 'on' days and 'off' days depending on whether they are 'on a roll' or not for that game. Exactly opposite to the gambler's fallacy, here the participants expect a trend to continue and not mean revert. Consider an example where after a few days of positive inflows from foreign investors into India, investors project more inflows while generalizing short term flows to represent long term sentiment towards the country.

➢ **Disposition effect**

Investors feel more pain and anguish from losses than the happiness they feel from gains. Checking prices frequently subjects them through an emotional roller coaster which is not good for their well-being as well as their investment decision making. Selling a position at a loss would be admitting that they were wrong. Instead booking a profit shows gives a sense of pride. Hence most of the time, investors tend to sell their winners and keep the losers in the portfolio in hope of recovery. This is the disposition effect.

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- **Base Rate Fallacy:**

  Base rate fallacy concerns the likelihood of an event occurring regardless of what the conditions of a particular situation may be. Investors who are affected by noise, often give higher weightage to new information and less weight to the original probability calculated. Suppose a company has a high probability (base rate) of outperforming the industry peers based on the strong business fundamentals, good management and attractive valuations. Assume the company declares weak earnings for one quarter. If the investor is changing the case for investing in the company with one bad quarter, the investors are giving high weightage to the new information rather than base case.

- **All that glitters…:**

  Researchers Terrance Odean and Brad Barber researched and proved that individual investors are net buyers of attention-grabbing stocks. When there are many alternatives, options that attract attention are more likely to be considered, hence more likely to be chosen, while options that do not attract attention are often ignored. They defined attention-grabbing stocks as stocks that are in the news, stocks experiencing high abnormal trading volume, and stocks with extreme one day returns. Certainly, investors would miss out on companies that are good investments but not currently in the news. Also, it is possible that investors will be entering the stocks after they have already experienced a major upmove, thus compromising their performance.

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The way out

A few years ago, I took a short boat ride from Hong Kong to a nearby island. Since I am not used to such kind of journey, I experienced some motion sickness. I asked my friend for some medication, but he suggested a simple remedy: "Stare at the horizon". I was not sure if it will work but it did. Later on, I did some search and found a good scientific explanation for the same. For investors too, the remedy for behavioral pitfalls during fast moving markets is quite simple: **Focus on the Long Term.**

When we step back and look at the broader, long term picture, we see things clearly. Investors should focus on broader business trends, verify the reliability of the sample data, anchor to base rates and adjust their views to new information based on the whether it is a signal or just noise.

I will end with another of my favorite painting from Magrtitte named "Clairvoyance". To me, it depicts the role of a good investor, a person who sees opportunities and potential that others might miss.

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Source - Wikiart

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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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