THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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By Nimesh Chandan

The Temptation of Short-Term Returns

"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas."

– **Paul Samuelson**

In 1970, Psychologist Walter Mischel conducted one of the most famous experiments in psychology called the Stanford Marshmallow Experiment. It involved studying the behavior of children who were 4 to 5 years old. Each child was brought into the room which had a table and a chair. The child was seated, and a marshmallow was placed in front of him/her on the table (in some experiments, the marshmallow was replaced by a chocolate or cookie or pretzel depending on what the kid loved). The researcher would tell the child that he would leave the room for some time. The child can have the marshmallow. But when the researcher returns, if the child has not eaten the marshmallow, he/she would get an additional marshmallow as a reward.

The choice for every child was: Eat one now or have two later (So cruel! 😉). Typically, the child would be left in the room for 15 minutes. Some children gave into the temptation quickly and ate the marshmallow as soon as the researcher left. Some struggled for a few minutes, trying to hold themselves back (maybe just staring at the goodie, or touching it) but ultimately gave in and gulped it down. Few kids were able to resist long enough to earn their reward.

Interesting experiment but what makes it so great? The important findings of the experiment came about only after many years! The researchers tracked the kids for years and studied how they performed in life on many different parameters. The kids who delayed gratification and waited to receive the second marshmallow ended up

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THE TEMPTATION IN INVESTING

Do adults fare better than the kids in such situations? Well, the temptations are different but many of us easily give into them, acting on impulse. In investing, the strongest desire that we need to fight is the desire to make quick short-term returns. A lot of investors enter the equity markets with the hope of making a fast buck. Especially when the market returns look good in the rearview mirror (like they do today), investors come in, believing the future holds the same returns for them. For the rally that the market saw from March 2020 to August of 2020, investors have forgotten that markets can go down too. Suddenly a good company that can give 20% compounded returns looks dull, when the market is seeing a lot of micro caps or penny stocks rising 20% in a day. These investors move their focus from business research to market timing. This doesn't anyway yield good results in the longer term. Plus, if the investors get their hands on some such 'bonanza' stock, the quantity they end up owning and/or the price they enter at, chasing the herd, does little to change their long term CAGR of the investment effort.

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As the primary markets get active during bull markets, IPO (Initial Public Offering) flipping strategies also resurface. Here the investors want to apply for an issue only to sell it on listing for a quick profit. Many don't even understand what business the company owns. Prices become just numbers and screen becomes a video game. Typically, the first set of primary issues are good quality and are reasonably priced. As frenzy picks up, companies with substandard fundamentals come to the market with highly priced issuances. Investors' due diligence deteriorates and skepticism (which is a useful tool for investing) diminishes. And losses ensure wiping away any superior return made in the strategy. Leveraged investors of course suffer more.

Last Friday, in India, the regulator announced changes in the asset allocation for Multicap funds, asking them to have a minimum 25% weightage each in smallcap and midcap categories by February 2021.

Suddenly, social media is flooded with investment ideas in these categories. The investment (and trader) community seems excited to buy smallcaps first thing Monday morning. This excitement in smallcap category is due to an increased allocation from a set of investors (Mutual Funds) rather than about the confidence in underlying businesses or its long-term potential.

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WHY WE EAT THE FIRST MARSHMALLOW?

Apart from Recency bias (described above) that affects decisions about short term movements, I have listed some reasons why our principles turn frail in front of temptation.

- **Overconfidence:** Generally, people are overconfident about their market timing ability as well as their driving skills. Imagine you are taking a long drive of 120km along with your friends. You take two cars. While you drive at the average speed of 60km/hour, you friend is going at 120km/hour. He obviously reaches early, boasts how easy it is and you are tempted to drive at higher speed on the way back. Of course, thinking rationally, taking that kind of risk is dangerous. There is a chance you may not reach the destination at all. Driving at high speeds and investing for short term returns requires high alertness, extra vigilance and very good luck.

- **Hyperbolic discounting or present bias:** When making intertemporal choices we discount the future incomes or joys quite significantly. Economists expect this discounting to move exponentially; for example, a value of 100 may be discounted at 10% a year to 90 after year 1, 81 after year 2 and so on. Psychologist have found that we discount at a hyperbolic rate which may be something like 100 going to 70 in year 1 and 50 in year 2. This very strong preference for "now" leads us to take decisions which satisfy us immediately. We don't correctly value compounding returns in the long term. Infact a lot of credit card or personal loan users hence end up paying significantly high interest rates for instant gratification or immediate consumption.

- ***Stress:*** In the previous articles we have discussed the two levels of thinking: system 1 (the spontaneous, effortless, reflexive system) and system 2 (the slow, deliberate, reflective system). System 2 checks the impulsive decisions of system 1. Under stress, the system 2 is less capable of handling system 1 decisions. Hence, we often experience that when under stress we may choose a high calorie chocolate cake over a salad. We give into temptation. The same happens in investing. When under stress on performance, we may choose to work on short term returns.

- ***False consensus effect:*** The implied assumption behind the confidence that one can make quick returns from an investment, is that others will also prefer the same investment and follow suit. "People tend to think others share their preferences… and want to jump ahead of the line before anyone else steals (their opportunity)", says Richard Thaler.

The lure of short-term returns is strong and takes a lot of discipline and effort to resist. Keeping positive nudges (read here) around to think about long term can help. The investment process should have tool like a checklist which help identify these biases and address them (written about it here). One can also pre-commit to certain steps in investment to avoid taking decision in the hot state (read here).

In a follow up study to the Stanford marshmallow experiment, some researchers gave the children an attractive toy to distract them from staring at the marshmallow all the time. That seems to have worked. A majority of the children that had the option of playing with the toy while they were waiting were able to resist eating the first marshmallow. Maybe there lies an answer for investors too. Rather than looking at the prices and updating portfolios all the time, invest time in reading about businesses and ideas that can help improve long term investment outcomes. A good investment process combined with patience and optimism will eventually lead to long term investment success.

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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).