THE STOIC INVESTOR

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Noise is to an investor what kryptonite is to Superman! It drains their powers (intellect) and makes them vulnerable

Achilles Heel and Investors' Ears

"Based on my own personal experience – both as an investor in recent years and an expert witness in years past – rarely do more than three or four variables really count. Everything else is noise."

– Martin Whitman

In Greek mythology, the King of Phthia - Peleus, falls in love with Thetis (a deity) daughter of the Sea-God Nereus and marries her. They are blessed with a son who is destined to be one of the greatest warriors in the history. There is another prophecy told to the parents, that their son would die at a young age. Worried about the well-being of her son, Thetis, takes the newborn to the River Styx. She performs a ritual to evoke the magical powers of the river water, that are supposed to make her son immortal. She dips her son in the river and all the parts of his body, that are immersed in the water, are blessed. Unfortunately, the heel from which Thetis held her child did not touch the water and was left vulnerable. The son is named Achilles and he indeed grows up to be the greatest warrior of his time. He is the key hero who wins the trojan war for the Greeks.

At the end of the war however, Prince Paris of Troy shoots a poisonous arrow at Achilles that hits him at the heel and that causes the death of the hero. The term, Achilles Heel, is hence used to describe a vulnerable point or a key weakness in an otherwise strong constitution. For investors, this vulnerable point is in their ears (metaphorically speaking) rather than their heel. All good investment ideas and plans are vulnerable to investment noise. Noise can be simply viewed as data or information flow that does not help in good decision-making process, infact deters us from it. It is the opposite of 'useful information' (academics use the word 'information' as useful input and everything else as 'noise') or a signal (market practitioners use this word instead). Noise is to an investor what kryptonite is to Superman! It drains their powers (intellect) and makes them vulnerable.

THE INVESTMENT NOISE

Being part of the equity investment world, we face two challenges:

a. There is a huge amount of information thrown at us every day. And it is multiplied and magnified (to garner more attention) with every hand (source) it goes through on the way to you.

b. Even with less information and understanding, most people tend to form a strong opinion about the movements in the equity markets. This is probably a unique feature in this world of equity investments compared to any other industry.

These two features lead to high decibels of noise in the markets. Investors need to practice ignoring much of the irrelevant information and opinions not founded on intensive research. For a good investor, the focus should be on i) long term instead of short term ii) change in value instead of change in price iii) understanding of an event and its implications instead of just knowledge of its occurrence. In pursuit of the information edge, if investors fail to make this distinction between the signal and the noise, they become susceptible to behavioral mistakes.

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I was able to find an excellent way of making the distinction between signal and noise in the book, "Before Happiness", by Shawn Achor (highly recommended). The author lists down four criteria of noise that is meaningless or distracting and that leads to errors in judgement.

Unusable: The information won't lead to any change in your behavior and action

Once we have defined our circle of competence and an area of focus, a lot of information outside of this is unusable. It just takes away a lot of our time and discussions about these data points don't lead to any better decision making. Unless we have any use of a particular topic or subject of information, keeping alerts, notifications, channels for that information stops us from using our time productively.

Untimely: we are not going to use the information imminently and it could change by the time we use it

This is where the distinction between short term and long term comes in. For a long-term investor, the constant in-depth analysis of a minute to minute change is just noise. It will just induce trading which will most often lead to suboptimal results.

Hypothetical: it is based on what someone believes "could be" instead of "what is"

A lot of people bombard you with their opinions disguised or presented as facts. All of it is just noise. In case of expert opinion too, research doesn't show a good hit rate in their forecasting skills. Plus, a lot of commentary and opinions in media are intelligently guarded, in the sense, they cover every possible scenario. "Hypothetical predictions, in almost all cases, are noise that drowns out useful information you could be using to make better decisions", says Achor.

Distracting: it distracts you from your goals

Any information or discussion that distracts you from your investment goals is noise

Any information or discussion that distracts you from your investment goals is noise. this is an important filter that every investor must keep a check on. Many a times, we drift into topics and discussions that consume a lot of our time and energy and end up taking us away from our goals and discipline.

Using the above four filters will help an investor avoid impulse reactions, save more time for productive effort and identify signals that benefit investment decisions.

USING THE NOISE

Once you have been able to successfully immerse yourself in the magical waters of River Styx or developed an investment discipline that makes your decision making process less vulnerable to noise, you can work towards understanding the impact of noise trading in the markets and endeavor to take advantage of it. In a seminal research paper by Fischer Black on ‘Noise’, Black highlights the impact, opportunities and challenges created by noise traders in the market. He defines Noise trading as a “trading based on noise as if it were information”. He says, most of the time noise traders, as a group will lose money by trading. But they provide high trading volumes and liquidity to the market. Some of the key observations, which are relevant to us in taking advantage of noise are:

- With a lot of noise trades in the market, it provides opportunities for those with (right) information to invest better (gives information edge).
- Because noise trading actually puts noise into the prices. The price of a stock reflects both the information that information traders trade on and the noise that noise traders trade on. Hence prices do not always reflect the exact fundamentals of the company. (opportunity for alpha generation).
- Overreaction caused by noise trading over and above information trading creates more short-term volatility in price compared to change in value (fundamental don’t change as much as prices).
- If an investor has information that has already been reflected in prices, trading on that kind of information will be just like trading on noise. (buy on rumors, sell on news).
- If the noise traders take the prices farther away from fundamental values, information traders will come in with large allocations. Hence prices over a long term move towards value. (payoff for a contrarian investor)
- Black also asserts that “Noise traders may prefer low-priced stocks to high-priced stocks… Low-priced stocks will be less efficiently priced than high-priced stocks”. (investors need to understand the difference between low denomination, cheap and underpriced to profit from this tendency).

Noise trading as a “trading based on noise as if it were information”

Noise can have a substantial negative impact on individual investment decision making. Our mind can get anchored on the most irrelevant information and yet drive the next investment based on that. One has to consciously create screens to filter the signal from the noise.

Noise traders create an opportunity for an investor by driving prices away from fundamental values

Noise traders create an opportunity for an investor by driving prices away from fundamental values. An intelligent investor 'lends an ear' to the noise only if it's worth her while.

CANARA ROBECO Mutual Fund

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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).