THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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Anchoring is a bias in which people, consciously or subconsciously, get locked on to a reference point, a psychological benchmark, which carries a disproportionately high weightage in their decision making.

Subtly influencing your free choice

"All my important decisions are made by my subconscious. My frontal lobes are just kidding themselves that they decide anything at all. All they do is think up reasons for the decisions that are already made" – Rex Stout, Writer known for Detective Fiction

Derren Brown is a famous British Mentalist and Illusionist well known for many of his (magic) tricks, especially with the playing cards. One of his famous tricks, which he even manages to conduct remotely on screen, goes something like this: He holds a playing card (face of the card not revealed) and tells you he is going to transmit the identity of the card to your mind (which he pretends to do). He asks you to imagine a card on "a vivid screen of your mind, with numbers on the corners, and things down in the middle". He then tells you to reveal what card came to your mind. You guess "a three of diamonds". He smiles, turns the card that he is holding, and voila, it's the same card!

How does he do this? Derren in his book, "Pure Effect", has revealed some of the secrets behind his 'psychic powers'. In this particular trick, he uses a process called 'priming'. When he tells you to picture a card, he makes some gestures that your mind subconsciously gets hooked on to. He says, "Imagine a vivid screen in your mind". While talking to you about the screen, he holds his fingers and thumbs forming a diamond shape. The word 'vivid' is used to prime your brain to think of a red card instead of black. When he is talking about "numbers in the corners and things down in the middle", he is using his thumb and two fingers all the time (pushing your mind to 3) and sneaks in the words "boom boom boom" when describing the "things down the middle". Most of the people picture 'the three of diamonds' in their mind and they don't even doubt that they were suggested the card. They believe that they chose it on their own.

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Researchers Alice Pailhès and Gustav Kuhn from the Psychology Department, Goldsmiths University of London, studied this trick to understand how the mind gets anchored (hooked on) to unconscious primes (suggestions) and affect people's decisions. The psychologists experimented with this trick themselves in a café setting. Though they may not have the magical flair of Derren, they were able to get "three of diamonds" as a majority answer from their subjects (and atleast 'three' or 'diamonds' from many).

ANCHORING BIAS

Daniel Kahneman and Amos Tversky studied this phenomenon under a larger umbrella called the Anchoring bias. Kahneman and Tversky conducted an experiment with a wheel of fortune which had number 1-100 on it. They had rigged the wheel to only stop at number 10 or 65 after spinning. Subjects were asked to spin the wheel and note the number they got. Then they were asked the question,

1. Is the percentage of African Nations among the UN members, larger or smaller than the number they got from the wheel?
2. What is your best guess of the percentage of African Nations among the UN members?

The number from the wheel couldn't possibly have any relation to the estimate of the subject, correct? Well, it did! Those who got the lower number, 10, in the wheel, guessed an average '25%' as the answer to question 2. And those who got 65 , averaged 45%. Several experiments have shown such correlations to the two numbers.

Anchoring is a bias in which people, consciously or subconsciously, get locked on to a reference point, a psychological benchmark, which carries a disproportionately high weightage in their decision making. It occurs even when people price or value different products and services. Marketers price a product at a high benchmark or a list price to anchor you to a higher number and then offer a discount (or yield to your bargaining) and make a sale to you at their pre-desired price.

ANCHORING WHEN VALUING

Dan Ariely, professor of psychology and behavioral economics, conducted an experiment where students were asked to write the last two digits of their social security number (national identity number) and put a dollar sign in front of it. Suppose, the last two digits are 89, they are changed to '$89'. Then they were shown 6 products: a cordless tracking ball, a cordless keyboard, a design book, a bottle of cheap wine, a bottle of expensive wine and a box of nice Belgian chocolates. They were asked to write the dollar number (they each derived earlier) next to those items on a piece of paper. They were asked, hypothetically would you pay that price for the products? Post that, they were asked what price they are willing to pay for each of these products (their bid)? When the results were analyzed, there was a strong correlation between the value of the last two digits of the social security number and the price each was willing to pay for the products. Even valuation gets anchored to seemingly random numbers.

In investing, where intrinsic value of the equity shares is difficult to calculate, anchoring bias has a significant impact. Investors are vulnerable to get anchored to less relevant or even irrelevant numbers. Most of the common anchoring mistakes that investors are susceptible to are:

- Most investors can get anchored to the **acquisition price of the asset** for any future decision about the investment. Rather than reacting on the change in investment argument and resultant fair value range of the security, investors measure everything from the cost price. This leads them to a) wait for break-even price in case the investment is in losses or b) book profits early if the asset price has moved up.
- Investors can get anchored to **historical growth rate and the historical returns** generated by the asset and start setting high expectations for the future. This may lead to disappointment and missing investment goals.
- A lot of investors consider the **52-week high and low prices** for their investment decisions (maybe subconsciously). Securities trading at 52-week lows are considered good investment opportunities, whereas, securities at 52-week highs are regretted as missed opportunities. In terms of future potential

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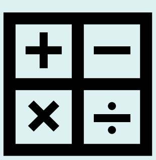
returns, the story may be entirely different. Fundamental value of a security at 52-week low can be lower and that of the security at 52-week high may be higher.

- Investors often anchor themselves to **high valuation companies** in a sector and buy the companies trading at optically lower valuations (a discount) hoping for closing the gap through upward rerating. Alas, such gaps may also close by a sharp fall in companies trading at high valuation!
- Analysts are also vulnerable to anchoring. Research has shown that analysts are anchored to their **previous estimates** and hence don't change their estimates enough after an earnings surprise. Anchoring is one of the causes of underreaction of the crowd and post earnings announcement drift in stock prices.
- **Recent prices and valuation** act as an anchor when investors undergo a valuation exercise. This may be due to the belief that markets are always right. Markets often overreact and hence considering current valuation range as permanent is dangerous.
- Even **experts** are vulnerable to anchoring. Don't get anchored on their recommendations 😉.

Anchoring may not be avoidable, but decisions can be guided to the right data with conscious effort.



ADJUSTING THE ANCHOR

Which year was Mahatma Gandhi born? If you don't remember the answer, you will probably start calculating from a relevant anchor. Like, Gandhi was assassinated sometime after Indian independence, so possibly 1948. He looked quite old and weak from his images of those times, so let's say he was about 80 years old at the time of his death. Working backward, one comes to birth year around 1868. The actual answer is 1869. Pretty close.

What we did here was anchor on the right data and adjust to reach the answer. Anchoring may not be avoidable, but decisions can be guided to the right data with conscious effort. Some of the ways to handle anchoring:

- Assume that one is always vulnerable to anchoring to noise and hence consciously remove irrelevant information or noise from discussions
- Fundamental investors are better off focusing on fundamental values rather than anchoring on technical data

- Think the opposite of an anchor. Find a counter argument. Do a premortem
- Make an independent estimate of the company before looking at market valuation. Better to be anchored at your own analysis
- Use long term trends and base rates as anchor to reduce vulnerability to recent or short-term movements.

Once the mind is anchored on something, it actively searches for confirming information (confirmation bias) and rejecting important counter arguments (cognitive dissonance).

Being anchored to irrelevant information can lead to mistakes in investment decision making. Once the mind is anchored on something, it actively searches for confirming information (confirmation bias) and rejecting important counter arguments (cognitive dissonance). Hence, a stoic investor needs to address anchoring at an early stage in the investment process.

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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).