THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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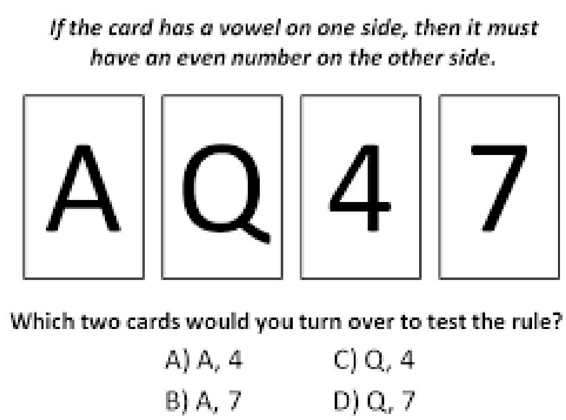
NORTH BY NORTH WEST

"The great tragedy of science – the slaying of a beautiful hypothesis by an ugly fact"

– Thomas Huxley

The title for this note, (as movie buffs would have already figured out), is inspired from the 1959 Alfred Hitchcock classic with the same name, regarded as one of the 100 best movies of all times. Although the movie is literally about the travels of the main protagonist, I use it to signify the advantages of exploring 'what can go wrong' with an investment while on a 'path to right decisions'. Before we dive into details, try and answer this question:



In the above exercise, majority of the people choose option A. While it may seem logical to select option A, since we are talking about vowels and even numbers, but it is not. If you chose that answer, you may be suffering from confirmation bias. To test the rule, you must actually try to falsify it. The card with the A is the obvious choice: if the card doesn't have the even number on the other side, the rule is broken. The card with Q is irrelevant; no matter what number is printed on the other side; it won't prove or falsify the rule. The card with 4 is also irrelevant because the rule only goes one way (read the question

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once more); an even number doesn't necessarily have to have a vowel on the other side. Card with 7 is important: if it has a vowel on the other side, the rule is falsified. Hence, card A and card 7 are the only cards that can prove that the rule is broken, these must be turned.

Most of the time people collect information that confirms their views. Once their views are formed, they prefer not to change them. Changing would effectively mean accepting that they were wrong about something earlier. While investing too, most people just want to be proven right and hence it is easier to drift towards data that reinforces the existing hypothesis. Opposing data is almost always assumed to weaken the investment case. This assumption, however, is absolutely wrong!

THE INSECURITY ANALYST

"I am not a professional security analyst. I would rather call myself an insecurity analyst."

– George Soros

In the book, "Soros on Soros: Staying ahead of the curve", George Soros mentions that recognizing that one can be wrong in decision making, and thereby being insecure about it, is actually a strength. Knowing what can go wrong in an investment, actually strengthens the case. Understanding the risks associated with a security doesn't make it un-investible. In fact, contrarian investors hunt for stocks where people have overestimated the risks. Actively seeking the opposing view provides the investor a checklist of areas to be monitored. Ultimately, event-based sell triggers can be incorporated in the investment thesis based on signals from these areas.

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According to Sir Karl Popper (20th century's most influential philosophers of science), Falsifiability defines the inherent testability of any scientific hypothesis. In investment, falsification of a hypothesis would mean knowing under what conditions would the argument fail. Not knowing these scenarios can put the investment to significant risk.

INCORPORATING FALSIFICATION IN INVESTMENT PROCESS

It is important to introduce falsification as part of one's thinking and investment process. Some ideas on how to implement are provided below

- **Always take an outside view**

  Nobel Prize winner Daniel Kahneman, in his early days at the Hebrew University, decided to join a few colleagues to write a textbook for students. The group was confident they can complete this project in two years. Kahneman decided to take an outside opinion from the Dean of the University on how many years it took other groups to finish such projects. The Dean gave a number that shocked him: "Not less than seven years" and 40% of the groups failed to complete. Kahneman and his colleagues, confident that they can do much better than average, pursued the project. Unfortunately, the project took 8 years!

  The story reveals the problems of relying on the inside view or focusing on the specific case and basing the decision on a narrow set of inputs. In contrast, outside view helps in determining base rates and experiences of others in similar conditions.

- **Invert. Always invert!**

  Charlie Munger often quotes Algebraist Jacobi saying "Invert, always invert" which means solving the problem looking backward rather than forward. He explains the logic by saying "I wish to know where I was going to die, and then I'd never go there". Under this technique, one approaches a question of "whether event X will happen", by turning it backward, that is, by studying "what can prevent event X". If forward thinking is about 'trying to be smart', inversion is about 'trying not to be stupid'.

  While forward thinking comes quite naturally to us, inversion needs to be incorporated as a step in the investment process to follow with discipline.

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- ***Practice second level thinking***

  Many market participants move in a herd, swinging like a pendulum between euphoria and panic and generating average returns. However, an investor who wants superior returns will have to stand out from the crowd and hence need to have a better framework of thinking about investments. Second level thinking is about looking beyond what looks obvious. Imagine a scenario where a company declares good growth in profits for the quarter. The first level thinker will rush to buy it. A second level thinker may find that the good growth was expected by the market and hence priced in the valuation. In fact, if the investors are still rushing to buy, the stock may be overvalued, and it is time to sell.

- ***Weighing data versus anecdotes***

  A lot of our decisions are driven by anecdotes and narratives. So much that anecdotes start overshadowing the important data collected for the decision. Typically, anecdotes are small sample cases which are generalized by the investors while taking an investment decision. Some of them may not be true representative of their population. The same holds true for quick polls and surveys. If the surveys are not properly planned and extensively conducted, they may show patterns which are significantly different from the ones in the total population. While discussing companies to invest in, it is important that data and anecdotes are weighed in the correct manner to generate superior outcomes.

- ***Do the opposite of Joe Bloggs***

  Adam Robinson is an American educator, author and a US Chess Federation life master. During his early days in tutoring, he found a pattern in the mistakes students made in writing SATs. The Math question papers during those days used to have 3 sections with multiple choice questions, arranged with increasing level of difficulty: easy, medium and hard. He found the students got the easy and the medium sections correct but did not score well on the hard ones. The answers to the hard questions were tough purely because they were counter intuitive. To help the students, he created an imaginary character called Joe Bloggs and asked them to imagine at every question "what would Joe Bloggs do?". Joe would provide the answer which seems right and comes to mind

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first. For the first two sections, the students were advised to select the answer that Joe would give and in the last section, do the opposite of what Joe would do.

Investment, similarly, is a counter intuitive decision. It is better to do the opposite of what Joe Bloggs would do. In a highly competitive market, the crowd won't leave any easy questions unanswered (easy investment decisions) for you. Don't do the obvious!

COURSE CORRECTION

Identifying and measuring risks increases the strength of the investment case and helps improve investment decisions which lead to better outcomes over a longer term

Trying to falsify the investment hypothesis using these mental models will highlight areas of risk. Identifying and measuring risks increases the strength of the investment case and helps improve investment decisions which lead to better outcomes over a longer term. This analysis can also indicate a course correction when the actual path of developments does not conform to the investment hypothesis. A stoic investor should not hesitate to change the portfolio when the situation demands. Like **Seth Klarman** said, ***"In investing it is never wrong to change your mind. It is only wrong to change your mind and do nothing about it".***

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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).