

THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

July 17, 2020, Issue #27

By Nimesh Chandan



When we are in the cold state, it is difficult for us to imagine how we will feel and behave when we are in the hot state and vice versa

BE COOL!

"Only when you combine sound intellect with emotional discipline do you get rational behavior"

– Warren Buffet

There is an interesting story in the Greek Mythology about their hero, Odysseus (also known as Ulysses in Roman Mythology). Odysseus had played an important role in the 'Battle of Troy'. In fact, he was the one who conceived the idea of the 'Trojan Horse', which ultimately led to the fall of Troy. After winning the battle, along with his crew, he was on his way back to his home – Ithaca. He was warned that the journey back home would be fraught with dangers, especially because he would pass by the Island of the Sirens. The Sirens were dangerous creatures, who posed like beautiful women, and lured the sailors nearby with their enchanting music and their singing. The sailors, mesmerized by their voices, would sail towards their island and find themselves shipwrecked and killed by the creatures.

Being the smart man, he was, Odysseus had prepared well for this problem. He filled the ears of his crew with bee wax so that they won't be able to hear the Sirens. For himself, he actually wanted to listen to the sirens and probably thought he could resist the temptation. But to be safe, he asked his men to tie him up to the mast of the ship and instructed them, not to release him till they have crossed the island. When they passed by the island, Odysseus heard the melodious voice of the sirens. He became so enchanted by their voice that he struggled hard to break his bonds to rush to them. The ropes cut deep into his flesh as he agitates. He begs his men to release him, but the men row quickly past the island and reach safe waters. They then untie their grateful master, who came back to his senses.

*But the “Doer” in us,
many a times, in the
hot state of emotions
does the exact opposite.
We give in to the greed,
fear and other biases
that lead to inferior
investment outcomes*



Reading this story, one can make many observations about self-control. Very importantly, this story goes deeper in highlighting a psychological bias (behind self-control problems) called the **Hot-Cold Empathy gap**.

THE EMPATHY GAP

George Loewenstein, Professor of Economics and Psychology in Decision Sciences at Carnegie Mellon University says that our decisions are based on the state of our mind. There are two states, our mind can be in:

The Cold state: This is the rational state of our mind/thinking wherein we are calm and comfortable.

The Hot state: This is the state of mind when we are overrun with emotions. And we act with impulse.

When we are in the cold state, it is difficult for us to imagine how we will feel and behave when we are in the hot state and vice versa. We are unable to empathize with our opposite state of mind. This is called the Hot-Cold Empathy Gap. Perhaps a simple example of this would be:

Imagine you are at the supermarket on a Saturday, buying ingredients for dinner you are planning to prepare on Wednesday. If you are starving while you are shopping, you will tend to shop more than your average food quantity. This is because when you are hungry, you imagine to be starving on Wednesday too. It is difficult for us to imagine feeling bloated on Wednesday. In the same way, if you are shopping after a nice seven course meal or a large buffet meal, you will tend to shop a bit less. You will feel stuffed and cannot really imagine being starving hungry on Wednesday.

BAD EXECUTION OF GOOD INVESTMENT PLANS

The empathy gap affects our investment decisions too. Borrowing the terminology from Richard Thaler, in the cold state we are good

Unfortunately, many of these investors find themselves yielding to the pressure and changing their stance, accommodating investment they would rather not take



“Planners”. We form a well-thought-out investment strategy and process that we decide to follow. We plan to be greedy when people are fearful and buy when the valuations are attractive. We also intend to be fearful when others are greedy and sell when the market has moved to euphoric levels. But the “Doer” in us, many a times, in the hot state of emotions does the exact opposite. We give in to the greed, fear and other biases that lead to inferior investment outcomes. The investment strategy is like a diet plan prepared by the Planner in us. But if the Doer in us gives in to temptations and often indulges in binging, we are not getting any healthier.

The Empathy Gap also affects our investment horizons. In the cold state, investors plan to reap the fruits of long-term investing and claim that they will not be affected by short term outcomes. They believe they can control envy even if in the short term their peer group, who is following a different investment philosophy, is doing much better than them. Unfortunately, many of these investors find themselves yielding to the pressure and changing their stance, accommodating investment they would rather not take. Benjamin Graham once mentioned, “Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions.”

THE HERO SHOWS THE WAY

Fortunately, Odysseus, the hero of our story has already shown the way to manage dangers of hot state actions. The first idea is simple but difficult to implement. Like the crew filled their ears with beeswax, cut yourself out from the market noise. It requires one to stop watching the price ticker, update the portfolio over longer intervals and distance oneself from noisy market participants. Unfortunately, this is not always easy as one needs to get some timely informational flow to make decisions.

What one can implement is what Odysseus did to himself: Commitment strategy! He got himself tied to the mast of the ship, to prevent him from changing his strategy when he gave in to emotions.

In the same way, when the Planner in us is making the rules, in the cold state, set up pre-commitments for the strategy

While pre-commitments may seem restrictive at times (during hot times), generally the investor will look back and appreciate the usefulness of these

In the same way, when the Planner in us is making the rules, in the cold state, set up pre-commitments for the strategy. Some of these ideas can work:

- If there are investments that qualify according to your checklist, but the prices are high, set up their buy prices in the system. If there is a selloff in the market and your preferred prices are hit, your system starts investing. This will prevent you from giving in to the fear during market falls.
- Sell triggers can also be set up based on the sell conditions. It can be either price triggered (when stocks become very highly valued) or event triggered (if the investment argument has changed).
- If the strategy has contrarian investment parts to it, set up a compulsory review of underperforming stocks periodically to review and evaluate for a possible entry at a certain price or event.
- Lock-ins can also be used. Closed ended funds are a good example of locking in a commitment. Trading locks can be put for investments made recently (time lock) or within a price range (price lock).
- Typically, when we meet managements or promoters of a company, we typically hear bullish arguments from them about their business. There is nothing wrong about that. Entrepreneurs need to be positive about their businesses and ideas. However, for an investor, valuations are also important. A no-trade policy can be kept internally on companies where the team has met the management in the past few days. This will help return the sentiments to return back to the cold state before investing.

There can be many pre-commitments designed based on the strategies one wants to pursue. While they may seem restrictive at times (during hot times), generally the investor will look back and appreciate the usefulness of these. It is also possible that these tools over time become a habit or muscle memory. That will enable the investor to resist emotional action even during hot states. Until, you reach that state of control, use these ideas and ... Be Cool!



NIMESH CHANDAN

**HEAD – INVESTMENTS, EQUITIES
CANARA ROBECO**

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).

Disclaimer:

The information used towards formulating this document have been obtained from sources published by third parties. While such publications are believed to be reliable, however, neither the AMC, its officers, the trustees, the Fund nor any of their affiliates or representatives assume any responsibility for the accuracy of such information and assume no financial liability whatsoever to the user of this document. This document is strictly confidential and meant for private circulation only and should not at any point of time be construed to be an invitation to the public for subscribing to the units of Canara Robeco Mutual Fund (CRMF). **Please note that this is not an advertisement or solicitation for subscribing to the units of CRMF.** The views expressed herein are only personal in nature and does not constitute views or opinion of Canara Robeco Asset Management or Canara Robeco Mutual Fund. The document is solely for the information and understanding of intended recipients only. Internal views, estimates, opinions expressed herein may or may not materialize. These views, estimates, opinions alone are not sufficient and should not be used for the development or implementation of an investment strategy. Forward looking statements are based on internal views and assumptions and subject to known and unknown risks and uncertainties which could materially impact or differ the actual results or performance from those expressed or implied under those statements.

**Mutual Fund investments are subject to market risks, read all
scheme related documents carefully.**