THE STOIC INVESTOR

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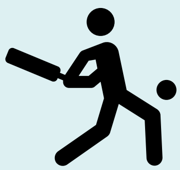
By Nimesh Chandan



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Thinking Process versus Outcome

"In this business, if you're good, you're right six times out of ten. You're never going to be right nine times out of ten."

– **Peter Lynch**

It has been almost 27 years, but a lot of Indian cricket fans remember the Hero Cup match between India and South Africa. It was the first Semi Final of the tournament held on November 24, 1993 at Eden Gardens in Kolkata. India won the toss and chose to bat first but could only put a score of 195 (of which Captain Mohd. Azharuddin contributed 90). South Africa started slow but picked up pace in the later overs and were steadily moving towards the target. After 49 overs, they needed 6 six runs off the last over to win the match. There was an intense discussion between the senior players and the Indian captain about who should bowl the last over.

All the regular bowlers Kapil Dev, Srinath, Prabhakar and Ankola, had some overs left to bowl. After consultations, the Captain decided to hand over the ball to the 21-year old Sachin Tendulkar. Sachin was a star batsman, but the whole Eden Gardens was shocked as he came out to bowl the last over. That over turned out to be magical! Sachin got a run out and restricted the batsmen to only 3 runs resulting in India's victory by 2 runs. The crowd was ecstatic as everyone lauded the captain for the brilliant move. Sachin was obviously the Hero of the evening; the media heaped accolades on the team.

Now… Let's imagine what if… South Africa had scored quickly on Sachin's bowling and won the game easily. What would be the reaction of the crowd, the media and the experts? Would anyone have spared the captain of severe criticism for such a bold decision that went wrong? Azhar later explained the he chose Sachin because he wanted someone who could take the pace off the ball. Fast bowlers could have been hit for big runs easily (Srinath went for 14 runs in the 46th over). Even if Sachin's bowling didn't click that day, the decision was justified. (Sachin actually repeated the feat in 1997). Would anyone give Azhar credit for this well thought out plan? Would people care to listen to or believe the justification?

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A lot of us tend to focus on the outcome to judge whether the decision was right or wrong. Not that outcomes are not important. However, when we consider decision-making in the context of uncertainty, outcomes are not the most important. The decision-making process becomes more important. In the context of investing, where decisions are made in uncertainty and use of probabilities becomes important, the outcome tells only a part of the story. If, after a scenario analysis, one finds an investment that has a 70% chance of delivering good returns, there is still a 30% chance that the future may not unfold as expected. For example, if a quant model is likely to work 70% of the times, there will be 3 years in a decade that the model will not deliver good returns. Imagine if those three bad years occur consecutively!

OUTCOME BIAS

When we evaluate the quality of a decision based solely on the outcome, we make an error called the Outcome bias. I picked up the table below from Michael Mauboussin's book, where he describes the process versus outcome matrix of Jay Russo and Paul Schoemaker:

		Process	
		Good	Bad
Outcome	Good	Deserved Success	Dumb Luck
	Bad	Bad Break	Poetic Justice

In the long run a good process delivers good outcomes.

This demonstrates that there will be times that good investment process can lead to some bad outcomes (Bad Break) and often a bad decision can lead to a good outcome too (Dumb Luck). However, in the long run a good process delivers good outcomes. Investors have to deal with uncertainty and accept some role of luck in their outcomes. Poker players call the outcome bias as "Resulting" where players judge the betting decisions on the basis of the outcome of the game. Resulting means people treat the outcome as an 'inevitable one' rather than a 'probabilistic one'. Annie Duke, a Poker Champion and author of book, 'Thinking in Bets' (nice read!) describes that *"a great poker player who has a good-size (money) advantage over the other players at the table... will still be losing over 40% of the time at the end of eight hour play. That's a whole lot of wrong".*

As investors, we must avoid the mistake of getting anchored to the outcome while evaluating the decision. We may end up giving credit to the wrong decision just because it turned out good. Outcome bias also reduces the capacity to take contrarian bets. Money managers or investors may avoid going against the crowd in the fear, anguish or regret of being wrong. Many may prefer to fail conventionally rather than take any risks of doing something different. This can lead to herding and index hugging too. The result is average returns or sub-standard returns.

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OTHER BIASES THAT SNEAK IN

Some of other important biases that creep into the analysis when evaluating outcomes are:

- **Hindsight Bias :** Nassim Taleb talks about it in "The Black Swan", Kahneman describes it in "Thinking Fast and Slow", and many other psychologists have spoken about the effect of Hindsight bias, also known as "I-Knew-It-All-Along" bias. Once we encounter a surprise, our brain tries to rationalize it in our mental construct. Once firmly incorporated, we lose the ability to recall our previous construct. In essence, we start believing this event was expected. Every crisis in the stock markets, every mistake investors made start looking obvious. Today a lot of investors will say "I knew we should have increased our equity exposure in March 2020". Hindsight bias gives us a false sense that everything is predictable. It is not! We have to deal with an uncertain future all the time.

- **Self-Serving Bias:** This bias is about giving oneself too much credit for the good outcomes and pushing all the negative outcomes to luck. It's like merging the two cells in the first row of the above table. It feels good emotionally but closes all opportunities to learn from the experience and improve the process. A related bias is the Blind-Spot bias, where one is able to see others mistakes clearly but not one's own. Our good fortune gets counted as skill while others bad fortune is regarded as bad decision-making.

HOW DO WE HANDLE THESE?

The right way to handle outcomes requires preparation prior to making a decision:

- Since we are handling uncertainty, a pre-mortem analysis or a scenario analysis of what can work and what can go wrong is required. Subjective probabilities have to be assigned to a bull case, base case and a bear case. It helps embrace uncertainty and understand probabilities and payoffs too.

- Make an investment journal recording why an investment decision is being taken. Input the assumptions and circumstances important to a particular decision. This will help looking at outcomes not just as numbers but analyze the reasons behind them. Comparing expectations with what transpired will lead to clarifying the role of luck, probability and process. One can improve the process accordingly.

- Build a process, follow the process with discipline, audit the process, improve the process! More importantly trust the process. Don't change it as long as outcomes are within the probability distribution.

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YOU DON'T NEED TO GET IT RIGHT ALL THE TIME

No one can get it right all the time. When asked about Berkshire Hathaway's amazing investment record Charlie Munger said *"If you*

The right investment process will provide the right combination of both the factors in a way that brings higher upside when you are right and lower downside when you go wrong

took our top fifteen decisions out, we'd have a pretty average record.... You stuck to your principles and when opportunities came along, you pounced on them with vigor."

Even George Soros has something similar to say in *"It's not whether you're right or wrong, but how much money you make when you're right and how much you lose when you're wrong."*

Investment decision-making is about considering the payoffs and their probabilities. The right investment process will provide the right combination of both the factors in a way that brings higher upside when you are right and lower downside when you go wrong.

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).

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