# THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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By Nimesh Chandan


## Learning to avoid a crash!!

**"True Ignorance is not the absence of knowledge, but the refusal to acquire it."**

**– Karl Popper**

In 1953, David Warren was working as a researcher for the Aeronautical Research Laboratories, a part of Australia's Defense Department, that was focused on airplanes. The 1950s were the early years of commercial airlines, and they were fraught with accidents and plane crashes. The experts who investigated these incidents found it difficult to identify the exact cause of these accidents. After all, the investigation team had no information except dead bodies and debris to work with. Even if there was an eyewitness, it was difficult to understand what happened.

David was made part of the expert team formed to solve this problem. He came up with an idea: what if there was a way to put a recorder in the cockpit of the plane that could store pilot voices and instrument readings of the flight? This would be of immense value to the investigators trying to understand the actual reason for the crash. Once they know what was going wrong, they can make necessary changes and save millions of lives. Of course, that box need to be strong enough to survive a crash. After making some prototypes and refining them, the world got its first "Flight Data Recorder" or what was later called the "Blackbox".

**Using the Blackbox helped the industry learn from failures and mistakes and put procedures in place to never repeat them**

From the 1960s onwards, the Blackbox became an essential device for every flight. It is actually orange in color and is made of material which is almost indestructible. It has two recorders: one records the voices in the cockpit and the other records the data from the flights electronic systems. If there is an accident, the box is opened, and data is analyzed and investigated. Using the Blackbox helped the industry learn from failures and mistakes and put procedures in place to never repeat them. Blackbox has led to a phenomenal improvement in the airline industry. In 2019, the number of fatal accidents in aircrafts was down to 0.18 per million flights or one fatal accident per 5.58 million flights. Much safer than driving on the road! (by miles 😉)

What can investors learn from airlines? Get an Investment Blackbox! It is known popularly as "Investment Journal" or an investment diary. Being a Star Trek fan, I like the name "Captain's Log" (remember Captain Kirk recording his decisions on a particular 'star date'?)

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## LEARNING FROM MISTAKES

Matthew Syed, in his book "Blackbox Thinking", has brilliantly explained the importance of feedback and learning from mistakes. He says "Blackbox thinking is about the willingness and tenacity to investigate the lessons that often exist when we fail, but which we rarely exploit". For investors, it is very important to understand the quality of their decision-making (investment) process; to understand their successes and failures; to improve their decisions and get better outcomes. For all this, one needs right and timely feedback. Because investors have to deal with complexity (interconnections between variables that impact the market) and uncertainty (uncertain probability distribution), the outcome isn't always the right feedback.

Like the airlines connect the flight statistics (data recorder) with the cockpit discussions (voice recorder) to determine the actual reason behind the problem, investors too need to connect their return statistics with inputs that went into the decision making to understand outcomes. This is where the investment journal comes in. An investment journal is any document or notebook where you record all the relevant inputs that led you to take a particular investment decision. Whenever you are taking a decision to buy/sell (invest/divest/switch) an particular security or asset, write down important information like: what is expected as a return from it, what is the reason for that return to be delivered, what is the expected time frame, any source of recommendation, any particular hypothesis etc.

The format or content can be customized based on the individual investment process or asset allocation strategy.

Whenever there is a review of the performance, connect the investment journal with the outcome (performance) data. It is bound to throw up many interesting observations and learnings. The performance of each decision will fall into one of the 4 quadrants: a. good decision, good outcome b. good decision, bad outcome, c. bad decision, good outcome, and d. bad decision, bad outcome. The review exercise will also show some shades of luck and skills impacting the performance.

## IMPORTANCE OF INVESTMENT JOURNAL

When Nobel laureate, Daniel Kahneman was asked, how can one improve the quality of decisions? He said, "Go to the drug store, buy a notebook". He advised having a book to record all the important decisions taken and then compare the outcomes with the expectations noted in the book. An investment journal is this book for investors! It is a behavioral tool that helps improving decision making by removing certain biases.

**An investment journal is a behavioral tool that helps improving decision making by removing certain biases**

**Outcome Bias:** In the investment world, decisions are based on probabilities of success rather than certainty. Nothing works 100% of the time. A good investment process can also lead to some bad outcomes. Outcome bias means the process is judged solely on the outcome. This leads to mistakes in evaluation and faulty changes in the investment process. As a result, future returns are negatively impacted. An investment journal provides critical input in evaluation of decision and helps towards better outcomes in the future.

**Hindsight Bias:** Also known as "knew-it-all-along" bias or "creeping determinism". Hindsight bias is a tendency of people to convince themselves after the event that they had accurately predicted it. This leads to people overestimating their abilities to predict an outcome and closes any learning opportunity from past experiences. The investment journal documents the thought process of the investors at the time of investment. Thus, preventing any hindsight bias.

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**The Investment Journal is a simple, cheap and effective tool to improve investment decision making and there by investment outcomes**

**Cognitive Dissonance:** It is difficult for people to admit to a mistake and hence there is a tendency to rationalize the decision by changing the argument or blaming it on luck or someone else. If the investors maintain an investment journal, they will avoid falling prey to this bias.

**Narrative Fallacy:** When people can't handle the complexity, they create stories to make sense of it. They interpret the outcome in a manner that sounds more logical and palatable to themselves. Nassim Taleb calls this the Narrative Fallacy. We become too eager to see patterns and explain the outcome even when we don't completely understand it. Without the investment journal, we become vulnerable to learn the wrong lessons or adopt flawed logics.

The Investment Journal is a simple, cheap and effective tool to improve investment decision making leading to better investment outcomes. The analysis will show some success formulas (strategies working consistently) as well as consistent mistakes (vulnerabilities). Using this tool, a stoic investor will unearth important lessons from both her wins as well as her losses.

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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).