THE LAST ITEM IN PANDORAS BOX!

Charlie: “Our investment strategy was simple. People hate to think about bad things happening, so they always underestimate their likelihood.”

Jared (Narrator): “Their strategy was simple and brilliant. Jamie and Charlie found (that) markets will sell options very cheaply on things they think will never happen. When they were wrong, they were wrong small. But when they were right, they were right big.”

– From the movie “The Big Short” (Scene introducing Brownfield Capital)

Like in any mythological story, this Greek one about Pandora also has different versions of the narrative. Here, I have tried to choose the popular one.

The titan Prometheus was the creator of mankind and a hero to humans. He did everything he could to help and protect them. Once he stole Fire from the Gods and gave it to mankind for their civilization. This angered Zeus (the God of Sky and Thunder also called the King of all Gods) and he wanted to punish both Prometheus and the humans for this insolence. He devised a plan and ordered the other Gods to create a perfect woman. This woman was blessed with the all gifts of beauty, wisdom and charm that the Olympian Gods and Goddesses could bestow. Zeus named her Pandora, which literally meant “all gifts”!

Zeus took Pandora to Earth to be Epimetheus’ (Prometheus’ brother) wife. Though Prometheus had warned Epimetheus against accepting anything from Zeus, Epimetheus was too enamored of Pandora to decline the proposition. As a wedding gift, Zeus gave Pandora a beautiful box (more like a jar). He did not disclose the contents of the
box but told Pandora never to open it; Pandora agreed. But as time passed Pandora grew increasingly curious about knowing what was in the box. Finally, one day, she couldn't resist any longer and she opened it. Suddenly all the evils started flying out of it. Hunger, disease, pain, hatred, war, death and other life’s miseries flew out of the box and settled in people’s homes. Seeing the horror, Pandora tried to quickly shut the box, but it was too late. There was only one thing left in the box: Hope. Eventually that too came out.

Hope in the box of evils?! This is where a lot of narratives split. Did Zeus decide to have some pity on the humans and add one gift that can help them cope up with the evils and continue to strive on? Or Hope of a good life will make people be tormented for longer? A lot of people have theories, but no one has the right answer. As far as investing is concerned however, you can confidently classify Hope as a problem.

WHAT IS HOPE?

Let’s clarify what we are talking about here. The best description of Hope I found was – it is “the anticipation of being positively surprised”. I love the irony in the statement. A lot of other definitions of Hope include words like expectations, desires, optimism etc. But that’s not the Hope we are talking about.

➢ **Hope is not expectations:** In a sports event, at a certain score your experience and knowledge might lead you to expect your favorite team to lose. However, you still hope for them to win. You carry similar emotions when you hear a negative news about the stock in your portfolio. You expect it will open sharply lower with the bad news. But you surely hope it doesn’t fall too much.

➢ **Hope is not desire:** Desire can be a fantasy; Hope is about what we perceive as possible.

➢ **Hope is not optimism:** Optimism is a personality trait and is more general. Hope is about a specific outcome. You can be optimistic about your success in investing in general; whereas you hope that the particular stocks you bought as a contrarian starts moving up soon.
IMPACT OF HOPE ON INVESTMENT DECISION MAKING

If you have done your research and bought the stock with the right arguments, at a valuation which is attractive, all you need to do is wait patiently for the value to be realized. There is a no need for Hope in the process. As Richard Russell put it “Any time you find yourself hoping in this business, the odds are that you are on the wrong path — or that you did something stupid that should be corrected”.

Hope in investment decision making invites biases that adversely impact portfolio returns.

➢ The Disposition Effect: Hope makes investors continue to hold losers despite incoming negative newsflow or even when the initial case for buying the stock is invalidated. Investors accept the risk of waiting for low-probability events or triggers. Under the same adverse circumstances, investors tend to sell winners but hold on to their losers. This is known as the disposition effect.

➢ Get-evenitis: Get-evenitis refers to the tendency of individuals to not cut losses short, and instead hold on to losing investments until they can be sold at the break-even price paid for it. Here the investors accept that they are wrong but yet hope to get out at the cost price. They don’t take the exit by booking a small loss as their minds are anchored to the purchase price.

➢ Negative drift: Assume that a company announces a significant miss in earnings and the stock price falls. Investor who are in the money, book profits immediately. Investors, whose purchase prices are higher than the current price, are likely wait for the better price (or breakeven price) to sell. Typically, these stocks underperform after the announcements as any price uptick is met with selling pressure. This is known as a post-announcement negative drift.
ROSE IN THE VINEYARD

If you have ever visited a vineyard, you would have noticed that there are rose bushes at that end of each vine row. They seem like a beautiful addition, but they actually have a role to play. Both rose bushes and grapevines are susceptible to the same infectious diseases. However, the infection becomes apparent in the roses at an early stage. This acts as a warning system to the farmers to take corrective action and save the crop from being destroyed.

The rose in the portfolio context can be an automated sell trigger system. Hope can act as an inertia that stops the execution of the right sell decision. If the investor can make an automated sell trigger based on price change (stop-loss) or a scenario change (for example – a profit warning announcement), he can possibly shield himself from taking a big loss later. This has proved to be an effective method to reduce disposition effect in experiments conducted by researchers Weber and Camerer.

It is difficult for investors to book a loss and hence they get anchored to the buy price (Get-Evenitis). A trick to handle this is by viewing the sell transaction, not as booking a loss but a one-to-one switch transaction. Here you are switching from one security (where the prospects have deteriorated) to another security (which is attractively placed) and hence you are not taking a loss, you are simply transferring assets.

Hope is a good emotion in many aspects of human life. Unfortunately for investing, it can tend to be a curse. Investors need to accept the cold reality as it is served. In investing, not everything unfolds as expected. One has to learn to live with probabilities and plan investments accordingly. There will be negative surprises along the way. For a stoic investor, surprises are opportunities to learn.
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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).

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