Heads - I was Right, Tails - The World was Wrong.
Devina Mehra explains self-attribution bias in stock investing

Investing, like most things in the world, is a game of luck cum skill but in the real-world investors weigh the two differently depending on how well they have done recently.

Last week, I was watching Rajiv Bajaj's interview where he mentions going to the village where his grandfather, Jamnalal Bajaj, was born. The latter was born in a poor family and once while playing outside was seen by a wealthy Sethji and adopted (for details of how that happened, you've see the interview). On that trip, he also met an employee - a security guard at Bajaj Auto - whose home was also in the same village and at that time it struck Rajiv Bajaj that he had made up so many stories about the reasons for his success like his hard work, skills as an engineer and a manager and so on but really if it had been that guard's grandfather playing outside on that fateful day, maybe that guard would have been the owner of Bajaj Auto and Rajiv would have been the guard!

This was a moment of epiphany for him and showed him the fallacy in attributing success to his personal qualities and efforts when luck or destiny had played a crucial role too.

This is a lesson that is awfully hard for human beings to learn as it is related to one of our inbuilt cognitive biases: the Self-attribution bias.

This is the fourth in my series on Cognitive/ Investing Biases. The earlier pieces can be read here, here and here

We attribute Outcomes to ourselves...but only if they're Successes!

This Self-attribution is not symmetrical in nature: it is not as if we attribute our success and failures equally to ourselves. Our tendency is to attribute successes to personal skills and failures to factors beyond our control. This, in fact, is the classical definition of Self-attribution bias.

Most of us can think of things that we’ve done and determined that when everything is going according to plan, it’s clearly due to our skill. Then, when things don’t go according to plan, clearly we’ve just had bad luck.

If we ace an exam, it is because of our intelligence, talent and hard work. But if we don't do well, it is because the rating was unfair or the professor did not teach the course properly.

When we are selected for a job, we believe that we have been hired for our achievements, qualifications and excellent interview skills. But if we aren't hired it is because the interviewer was prejudiced or there was some other hanky-panky afoot. That is how the human mind works.

In investing, self-attribution means if I pick a stock and that does well, it's because I'm a genius. But if the stock doesn't do well, then it's because of external factors - the economy, politicians, company management, stock operators, there are plenty of factors that can be blamed.

So success is because of my skill. The failure is because of some risk that could not be foreseen.

Of late, many who have opened accounts in the likes of Robinhood think of themselves as accomplished traders - that too in a foreign market! They don't stop and analyse that maybe I was just lucky enough to enter the US market at a good time. Similarly, those dabbling in cryptocurrencies think of themselves as extremely savvy in digital assets when they make money and curse everyone from various governments to Elon Musk when some news makes their holdings crash.

Investing is a game of luck cum skill

Investing, like most things in the world, is a game of luck cum skill but in the real world investors weight the two differently depending on how well they have done recently. Several studies have shown that this is a real phenomenon.

So if in the past year, you've done very well, and then you are asked that what percentage of your investment performance do you attribute to skill, you are likely to give a much higher percentage than you would if you had not done well - then the luck factor would have been rated higher.

Why does the Self-attribution Bias exist?

As with most cognitive biases, the apparent 'mistake' in our thinking has a positive evolutionary role.

This cognitive bias allows you to protect your self-esteem. By attributing positive events to yourself, you get a boost in confidence. By blaming outside forces for failures, you protect your self-esteem and absolve yourself from personal responsibility.

One advantage of this bias is that it causes people to persevere even after a failure - whether it was a failed hunt or a lost race.

When you can blame luck/ outside forces for it, you're more likely to try again. For instance, an unemployed person may feel more motivated to keep looking for work if she attributes her joblessness on a weak economy or discrimination rather than some personal failing.

Why this can be a road to disaster in Investing (or Trading)

So, anything that boosts your confidence and self-esteem should be good, right? Only if you are in school! In the market it can be a disaster.

Taking credit for successes and blaming external factors for failures underlies and reinforces investor overconfidence. Every success is attributed to great analysis and skill whereas every failure is because of "bad luck".

The result? Taking on inappropriate degree of financial risk, trading too aggressively increasing downside probability, overtrading are all known results. Self-attribution bias often leads investors to trade too much and take on too much risk. All signs of overconfidence.

It can also result in concentrated positions because you're so convinced of the brilliance of your analysis. This bias leads investors to “hear what they want to hear.”

All of the these things to be avoided!

As an aside, studies show that men are much more prone to this overconfidence and overtrading outcome compared to women.

Equally important, not taking responsibility for your errors means that mistakes in thinking, frameworks, ways of analysis etc continue unchecked because you refuse to admit that there was anything wrong with your decision-making process in the first place.

Thus, you're doomed to repeat your mistakes over and over again

"Don't Confuse Brains with a Bull Market"

As this quote says, the step one for an attempt to side-step this bias is to know how much of your gains are due to the luck of being in a certain market at the right time. When profits pour in during a bull run, it is easy to congratulate yourself and your outstanding analytical skills.

This happens not just with lay investors but even professional fund managers who arguably have even greater incentives to do this in order to justify their fees.

Always remember that in both successes and failures there is a combination of skill and luck.

Your mind should not skew your thinking such so that you think that everything that does well was due to your skill and everything else, "Poor me! I could not have foreseen that. Bad luck".

In real life investing, both failures and successes have elements of skill and luck but in the investors mind the success is all skill and failure is all luck.

One other trick which helps reduce the impact of this bias is writing down your logic for why you are taking a certain investment decision so that later on whether it turns out well or not you can go back and check whether your logic was correct. This is important even if your decision turns out right. Even if you make money on an investment, your logic for taking the position may have been totally wrong and the 'right' outcome may've been only a lucky fluke.

If you do not write your logic down BEFORE you make this investment, you can rest assured that your mind will play tricks and tell you that you always knew what really happened, which is another cognitive bias altogether that I will deal with some other time.

Of course, when the outcome is not as per your liking/ estimates, go back and study your decision-making to see where the mistake or error was.

Another important thought: a positive outcome does not mean your decision was correct just as a negative outcome does not mean your decision was incorrect.

In investing your decisions are always made with many unknown factors and hence there is always an element of luck.

But that's a topic for another article altogether.