Print This P

Why Human Beings are hardwired to make the wrong investment decisions

When you switch on your laptop or mobile, sometimes, a disconcerting ad pops up talking about a young girl with three siblings who cannot afford food or school fees, or maybe, a parent asking for money for a life-saving surgery for their child.

An ad like that is bound to generate a degree of guilt, particularly in a situation of no-response.

Now flip the side. Ever wonder why, in contrast, there is negligible emotional response while reading about how 30 percent of children in your district are malnourished or how many million cancer patients do not have money for their treatment?

The reason is simple: human beings are hardwired to respond to stories. While impersonal statistics are easy to ignore, stories are not!

Human beings have always been the tellers of and listeners to, stories. Go back to when humans were still living in caves - they would return and tell stories about their hunts, which is what people see in the cave paintings.

Stories are the best way to pass on knowledge, wisdom, and information to the next generation. Children everywhere not just like stories, but they also find them the easiest way to learn things - something which was well understood by Vishnu Sharma when he wrote the Panchatantra.

Anthropologists say that stories exist in all cultures across all time periods, regardless of the level of sophistication.

It can be said that stories, in a very real sense, are what make us human.

Great. So, what is the issue here?

The issue is that not just stories, but also many other ways of thinking that make us human, the very aspects that derail our investment journey.

This is the fascinating part - what we call quirks of thinking or biases today have had a real and valuable role to play in our evolution. So, at some point in the evolutionary cycle, these were very good attributes to have - possibly when man was a hunter-gatherer or when he had to escape from a saber-toothed tiger.

But, investing is something very new in human history. And, when that same instinct, the same way of thinking, the same biases come into play while investing, they can change outcomes dramatically.

In theory, as an investor or even as a trader, understanding all the tools of the trade and the number crunching is very easy. Yet in the real world, we find that we are not as successful in investing as we should be.

The gap there really lies in understanding one's own mind, in understanding the human mind and how that, at times, can derail a person from what he or she wants to achieve.

I am excited about starting this series on cognitive or thinking biases of the human mind, which have a direct impact on your investment journey.

The first bias we will be discussing is Storification

It's not accidental that almost all ads, including the ones mentioned in the first para, are in the form of stories rather than a dry list of attributes or statistics. Stories work when there is a human being on the other side.

Stories are much more powerful and memorable - hence satisfying to us.

For example, if a fund manager is trying to convince investors to invest with her/ him and comes up with this nice little story - `I am investing in this company because it has great brands, predictable cash flows, manages logistics very well etc. or why this particular management has a magic touch' - as an investor, most human beings will get convinced.

But, the problem is that when you're investing, on the other side there is no human being - there's the market, which doesn't really care about how beautifully your story is crafted or how many people believe in it.

First, many would be able to think of instances, when the story that was told about the market or the stocks not playing out the way everyone said it would!

Number Two, what happens is that a story, by definition, has to be reasonably simple. So there has to be a beginning, cause, effect and an end. That's what you want.

However, life is much more complex. A company has hundreds of financial parameters and there are many business decisions that can change its outcome.

Then, there are not just its own decisions, but others that are allied - how the market is changing, how the consumer is evolving, and what the competition is doing.

In the interest of a good story, one needs to discard all of that and turn it into a very simplified and therefore inaccurate and under-analyzed story.

Number three, life is not deterministic. It is about probabilities, but stories have a beginning, middle, and end. No one likes a

movie that ends saying that there is a 60 percent probability that the hero and heroine get together and get married, a 30 percent probability that they get married to other people, and 10 percent probability that they don't get married at all. That's not a good story!

In investing, there is a whole range of outcomes that have different probabilities attached to them. But, a fund manager or investor often gives his/her holdings a rosy future without risks - ignores discordant elements (industry cycle, favourable policy or plain luck) and that is where it becomes dangerous and risky. The world is a lot more complex than what simple stories tell us.

Also, remember that for a fund manager or investor to be wrong does not mean that they were talking complete nonsense all along. Neither that their stories did not have a kernel of truth - good stories always have that. It is only that it was being used to describe something that was much more complex like an industry, a company or a country that had many more moving parts and what actually happened was a lot different from what was predicted.

As Morgan Housel – partner at The Collaborative Fund and a former columnist - writes "...something that's true but incomplete might be more dangerous than something that's wrong because a little truth is a fuel for a lot of overconfidence."

Number Four, as human storytellers we get invested in our stories because they then determine our self-worth and net worth.

As we repeat that story, we get more and more convinced about it. We become invested in not just the stock but also our story about the stock. And because of that, it becomes very difficult to change our mind and the best among us fall for that!

If you look at Warren Buffett, he sold - in a sense – the Coke story for a long time - that great brand (of course, it was the number one brand in the world for decades), predictable cash flows, the moat around the business, etc.

Of course, like all great stories, none of these factors were incorrect or untrue, but they still did not capture all the changes that were happening in the company and the industry around it, including how the consumer was evolving away from sugary sodas, Pepsi was moving faster on a variety of fronts and so on.

Now, look at what happened to Buffett's Coke position. Mind you it did very well for several years after he bought it, but then things changed. However, by then he was arguably so invested in his story that he could not change his mind. He held on for far too long!

Then if you look at his Coke investment from 1993 to 2020, it went up only eight times. In that time the S&P 500 itself went up 13 times, and Pepsi 30 times!

So the story derails not only the audience but also the storyteller because ultimately the storyteller also gets convinced of her/his story.

Ask yourself what investing story you are buying into - maybe about a whole market, a sector or a stock. Check whether it makes complete sense or are you discarding some facts and data which do not fit in with your story.

Even if the story currently makes sense, is that permanent?

Consciously challenge all the assumptions that have gone into making that neat little story in your head. Think of alternative endings to the story instead of the one you've been propagating.

Do all this and you just may be able to distance yourself just a bit from the Storification bias!

Look forward to meeting you in a few days with another human bias...or two.

(Devina Mehra is a Founder and Chairperson of First Global, a Global Fund Management company. She tweets at @devinamehra)

***Disclaimer**: The views and investment tips expressed by experts on Moneycontrol.com are their own and not those of the website or its management. Moneycontrol.com advises users to check with certified experts before taking any investment decisions.*