Unforced Errors:

Mental Mistakes in Investing

TRIAD INVESTMENT MANAGEMENT

It's well-documented that most investors prefer avoiding the pain of losses more than the pleasure from investment gains.

We all buy stuff, probably too much if you're like me. Stuff is usually thought of as tangible or having physical properties, but we live today in a service-oriented economy, where we are paying for intangibles, or services as might be delivered by your doctor, hair stylist, auto mechanic, or investment counselor.

Physical "stuff" is relatively straightforward to successfully deliver. You pay for it, and it's yours. Service delivery is very different. The key is the quality of the service. How many times have you left a restaurant and felt the service was outstanding? If you're like me, it doesn't happen enough. Or maybe I'm going to the wrong places. But when it does, we generally sit up and take notice. Outstanding results in the world of professional services, and especially in our world of investing, are unique as the best outcomes happen when the relationship between client and investment manager creates a deep trust and understanding of the goals and motivation of each party.

It's not an equal split of duties – the professional spends significant time delivering specialized advice based on his or her credentials, training and years of experience.

Unlike purchasing a car, refrigerator or shoes, providing professional services relies to some degree upon the client. Why is that? Ultimately it comes down to client behavior. Is the client willing and able to act in a way that leads to a successful litigation outcome, tax review or investment result?

Of course, most clients intend to help. While we can't speak for attorneys and accountants, we can say that in the publicly-traded investment world, negative behavioral tendencies tend to recur, and can create mental roadblocks or blind-spots that can keep investment clients from achieving satisfactory results. Let's review three common tendencies, with some suggestions for counteracting these natural human biases.

Confirmation Bias

Confirmation bias occurs when an investor searches for and uses information that agrees with his or her ***preconceived*** views of an investment, and gives much less attention to alternative viewpoints.

Let's assume Steve buys stock in a shoe manufacturer (Alpha Shoes). Then, he makes a point of noticing favorable stories about the company in the press, buys a pair of the shoes, notices the shoes at local stores and sees that others seem to share his taste and are also wearing them.

What Steve might not be observing is news about a competitor (let's call them Beta Shoes) that is launching a line of similar looking shoes at lower prices. Or noticing that the executives of Alpha shoes are selling their shares in the company.

There are few clear cut answers in investing but it's vital in our view to study both the pros and cons of any investment. Charlie Munger, vice chairman of Berkshire Hathaway and a noteworthy investment thinker, puts it this way:

> *"I never allow myself to have an opinion on anything that I don't know the other side's argument better than they do."*
> **— Charlie Munger**

Get out an old-fashioned legal pad, and use it to list the cons as well as the pros to any investment you are considering. Many investors also make a point of seeking out information that is contrary to their position, another good idea. Ultimately, an investment will respond to the reality of the facts, not your opinions.

Hindsight Bias

Hindsight bias is the "*I knew it all along*" tendency. The rapid sales growth of the iPhone – oh, I predicted that! The housing crisis? Saw it a mile away! We tend to remember our forecasts as being better than they really were, and selectively remember the "right" ones. This can make us think that we are pretty good forecasters which can lead to poor investment decisions if we're not careful.

Accurate forecasts would be very helpful in investing--if they could be reliably achieved. But we've found it's hard for us and others to accurately predict pretty much anything – including the weather, interest rates and the direction of the stock market in the near term. Fortunately, it's our view that most investments do not require the use of a crystal ball.

When an investment relies on your ability to accurately forecast the future, remember that hindsight bias might be in the background, quietly egging you on. Be careful.

Loss Aversion

It's well-documented that most investors prefer avoiding the pain of losses more than the pleasure from investment gains.

For example, an investor sells a successful investment but maintains investment in a losing investment to avoid realizing the loss and feeling the pain. Or, as often can happen, buys more of the losing investment to try and regain the lost money and get back to even.

An assumption in this behavior is that an underperforming investment deserves additional funds and is due or entitled to return to its previous levels. We don't agree with this premise. Everything that has happened to an investment in the past, is in the past - the focus should be on the future. What are the future prospects of the investment? If the answer isn't a pleasant one, then action needs to be taken today even if a loss will be realized in the process.

-Dave Hutchison

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