Chapter Nine: *Humane But Not Human*

by Nathan Polackwich

Benjamin Graham, the father of value investing, was once described by his third wife as "humane but not human." Though clearly not conducive to marriage, Graham's inhumanness may have given him an investment edge. Specifically, scientists have discovered that a defect in a part of the brain called the amygdala can shut down the emotions of attachment – emotions that are a root cause of irrational behavior in the stock market.

While counterproductive in investing, our attachments do serve a biological purpose. Why are parents so devoted to their children? Sure, they're cute and say funny things, but that's only part of it. Though admittedly cold and clinical, the evolutionary reason parents provide for their children is to increase their offspring's odds of propagating their genes. And the more effort put in, the greater the attachment.[1] But emotional attachment to things in which we're invested doesn't end with our children. It also happens with ideas. This can be especially problematic for investors, as the stock market demands a fox-like ability to quickly change course when confronted with compelling and dissonant information.

Those of us with a functioning amygdala, then, find ourselves at a disadvantage. But the good news is if you're aware of your handicap, if you "know thyself," you can learn to protect yourself *from yourself*. Your emotions may impact your anxiety level, but they needn't affect your judgment.

The Playbook

1. **When researching ideas, start with no preconceived notions.** As Sherlock Holmes advised, "It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts."

2. **Limit your information to high quality sources.** The news media is not designed to accurately represent reality. Its purpose is to grab your attention, a feat best accomplished by appealing to your emotions. Thus, we see a surfeit of stories on titillating topics like terrorism and attractive crime victims (the younger and blonder the better) rather than more mundane issues like car accidents and heart disease, which nevertheless are far more likely to affect the average person.

Demand context and depth from your sources of information. You'll find neither on T.V., which should only be used (and sparingly, at that) for entertainment. Well researched articles in newspapers are good, as are weekly and monthly magazines and journals. I find that time constraints make books more useful for improving your investment process than generating investment ideas.

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[1] It has been my experience that the more you do for someone, assuming they're worthy of the effort, the more you grow to love them.

3. **Limit your information period.** While you want to be aware of as many reasonable sides of a story as possible, be careful of ingesting *too much* information. This can make it difficult to see the forest for the trees.

The first person I met in the investment business told me about a financial analyst who covered Xerox. This analyst knew everything about Xerox but was utterly incapable of making any recommendation concerning its shares. She suffered, as this investment advisor put it, from "paralysis by analysis." The more she learned, the more she realized she didn't know. The more she realized she didn't know, the more she felt she needed to learn. Foxes often confront this dilemma.

While openness to alternative viewpoints is a prerequisite of good judgment, foxes can occasionally be too open. Thus begins a self-reinforcing cycle where the fox gathers information, which leads to less certainty and the desire for more information, and so on. Ultimately, the fox becomes so mentally entangled he can't make a decision. The debilitating nature of this vicious circle probably explains why the ranks of the Federal Government overflow with confident hedgehogs rather than more knowledgeable but fox-like scientists and academics.

In *The Black Swan* Nassim Taleb describes a study where two groups of people are shown a blurry image of a fire hydrant. In one group the resolution increases to a clear picture in ten steps. The other group sees the resolution increase in just five steps. If you freeze the partially blurred image at the same point for both groups, the group that saw fewer steps is quicker to recognize the image as a fire hydrant. Apparently, the more steps you see along the way, the more you can theorize on what the image is, and the harder you find it to change your mind as the picture becomes clearer.

4. **Focus on the underlying business, not the stock price.** Warren Buffett once said that the smartest thing ever said about investing was his mentor Benjamin Graham's statement that "Investing is most intelligent when it is most business-like." What Graham was saying is that when you buy a company's stock, you're not just an owner of a piece of paper. You are an owner of the company. You are a businessman. *And as a businessman what should most concern you is the operating performance of the company or companies you own*. The price at which the market chooses to value your stock at any moment in time is only relevant to your decision each day to change (or not change) your ownership stake in the company. Buffett further emphasized the importance of this mindset with his description of "a remarkably accommodating fellow named Mr. Market" who investors should imagine as their partner in a private business:

> Without fail, Mr. Market appears daily and names a price at which he will either buy your business or sell you his. Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains.

> At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.
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> Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.
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> But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find most useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence.

Focusing on a company's underlying business is most helpful when deciding to sell a stock. As long as the underlying business is performing as well as you had originally anticipated when you bought the stock, you shouldn't let Mr. Market's negativity alter your viewpoint. On the other hand, weak trends in a company's fundamentals shouldn't be ignored just because Mr. Market is momentarily optimistic.

5. **Synthesize the information you've gathered to form your opinion.** Be a fox. Get the information and cancel out the errors.

6. **Don't bother thinking too far ahead.** Professional chess players usually think just a few moves ahead. The future is too uncertain for long-range (more than 3-5 years) prognostications.

7. **Think in terms of a range of probabilities, or expected value** – Rather than basing your decisions on what you think is the highest probable outcome, consider a number of possible outcomes. A stock is at $10 and you believe the odds favor it going to $20 in three years. Don't base your decision to buy the stock on that one data point. If there is also the possibility of a huge loss – say a 40% chance of a drop to $2 – then the stock may be a bad buy. In this case, its expected value is only $12.80 ($20 x 60% + $2 x 40%). Now consider a $10 stock with a 90% chance of going to zero and a 10% chance of going to $200. This stock has a much better expected value of $20 ($0 x 90% + $200 x 10%). Note that all of your probabilities must add up to 100%.

Thinking in terms of a range of probabilities (I use three: a base (or most likely) case, a worst case, and best case) provides important psychological cover because you acknowledge before you make a decision the possibility of being wrong. Bets with an 80% probability of success still fail 20% of the time. Accepting this gives you the freedom to make decisions without trying to attain the unattainable – perfection. So when a bet does go against you, you can simply consider the loss a cost of doing business. By framing losses this way helps you avoid emotional attachment, acknowledge the mistake, and move on.

8. **Adjust probabilities based on the ease with which the outcome can be imagined and the emotions it evokes** – The greater the affective meaning of an outcome and the more easily it can be visualized, the higher the probability people tend to assign its occurrence. For instance, an act of nuclear terrorism in a U.S. city is a highly affective, easy to visualize outcome. Thus, most people overestimate the chance of it happening.

9. **Adjust probabilities based on the fact that change often takes much longer to occur than anticipated.** Why do people often severely underestimate how much it will cost and how long it will take to renovate their house? The reason is the psychological phenomenon of "tunneling." When making estimates, people tend to ignore all the little things that can slow down a project's progress and increase its cost. Tunneling's application to investing is that change takes time. Struggling companies or economies don't turn around over night. Conversely, when business is booming, the inevitable bust always feels right around the corner but usually takes longer than you expect to finally unfold.

10. **Adjust probabilities based on whether you own the stock** – Ownership of a company's stock tends to make people more optimistic about its future.

11. **Once you've made a decision, seek only dissonant information.** Let's say that you believe American Express is a good company with an undervalued stock. At this point, additional information that supports this opinion is of no value. If you already own American Express, you'll continue to own it – nothing will change. Thus, the only information that could lead to action – and therefore the only information of value – is that which suggests American Express is a bad company with an overvalued stock.

12. **Act only when an opportunity is significant.** Recalling Warren Buffett's idea of a punch card with twenty slots, players of the Winner's Game must focus on making fewer and hopefully better decisions. As we know, the stock market is infinitely complex and unpredictable and thus not a business of precision. Expect to be able to recognize just a handful of great opportunities in your career, and don't be afraid to make a significant commitment to them. You can't win the Winner's Game by spreading your bets around dozens of mediocre ideas (remaining heavily diversified is, however, key to not losing the Loser's Game). Rather, focus your bets on your best ideas and follow them closely. Aside from potentially improving your potential for gains, acting only when an opportunity is significant can limit your downside.[2] If you buy what you believe to be $1.00 of assets for $0.50 (seemingly a great opportunity), and it turns out the assets are only worth half what you thought, you can still avoid a loss.

13. **Keep a journal of your decisions and your reasons for making them** – This helps neutralize hindsight bias, which encompasses two tendencies: First, people often view events as having been predictable *after* the fact. Oil prices double in a year. With hindsight, it may seem like this outcome was inevitable. But prior to it happening, the truth is that it wasn't clear at all where oil prices would go. There could have been a huge find in the Gulf of Mexico. The bursting of the Chinese stock market bubble could have crippled the Chinese economy dramatically reducing auto sales and gasoline consumption. By keeping track of your thoughts

[2] Buffett calls this his "margin of safety."

when you make decisions, you won't be fooled into viewing the path of history as easy to foresee.

The second component of hindsight bias is the tendency to remember your prior predictions in a more favorable light. But by failing to recognize your mistakes, you can't identify where you went wrong and improve your decision-making.