Chapter 21

Avoid Common Psychological Challenges That Impede Sound Investing

Introduction

You're probably aware that the human mind can deceive even itself, but you're also probably thinking, "It never happens to me." Your belief is justified by the fact that you possess above-average intelligence and are analytical in the way you make decisions. After all, these traits are what make you a great equity analyst. But the reality is that you're not immune. I've seen the most common psychological mistakes occur to some of my closest colleagues, including some of the brightest analysts in the industry. I've been regarded as very logical throughout my adult life (sometimes to a fault), and yet I'll confess that I've made many of these common mistakes myself. So before you go any further, open your mind to the possibility that you could be fallible in this area too.

Understanding how to avoid psychological pitfalls should be a top priority for every equity research analyst, followed closely by

understanding how to exploit these mistakes when others make them (often the S in the FaVeS framework). Our mind plays tricks on us, which can lead to bad decisions. Nowhere is this truer than in the investment process. This isn't just my opinion, but a fact that's been supported by decades of academic research. As much as I want to keep this discussion geared toward the practical aspects of equity research, the reality is that academic studies help demonstrate where the human mind stumbles. Modern Portfolio Theory (MPT) assumes that investors are always rational, but any experienced practitioner knows this is nonsense. There is a psychological dimension to all investor decision making, whether it's recommending stocks, revising earnings models, or even writing a research report. Human beings invariably drag their emotions into their decisions, with the cognitive errors discussed below often being the result. No one can escape these; they are systematic and have a direct effect on pricing (Schoenhart, 2008: 4–5). As such, there's no failsafe system to ensure that you'll never fall into a psychological trap, but being aware of the common pitfalls should allow you to know when they're more likely to occur.

Not recognizing or compensating for psychological traps can lead you (or those you compete with) to:

- Be unjustifiably optimistic or pessimistic (Trammell, 2003: 46–47).
- Be overconfident in abilities and prospects, thus lowering the effort spent investigating risks to an investment thesis.
- Subconsciously overlook important information (Schoenhart, 2008: 78), distort facts, or fail to accurately perceive reality.
- Sell or buy with the herd, at the worst possible time.
- Fail to learn from investment mistakes, and thus risk repeating them.
- Fail to recognize how biases can distort earnings forecasts and valuation analyses.

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