Becoming a Better Investor Through Random Trivia Questions

What is the average gestation period (in days) of an Asian elephant?

How many square miles are on the surface of Lake Michigan?

What is the average annual snowfall in Anchorage?

And, more importantly, what do those questions have to do with you becoming a better investor?

Unless you are a zoo veterinarian, Great Lakes trivia buff, or an Alaskan meteorologist, you probably have no idea what the answers are. But, if you are like most people, that won't stop you from being over-confident in your ability to guess the correct answers.

There is a 10-item test with similar questions that has been posed to thousands of people over the years. The goal of each test taker is to give a range of possible answers so that one can be 90% confident that the correct answer lies within that range. For example, one might guess that it takes anywhere from 200 to 500 days for an Asian elephant to grow a baby (and, by the way, one would be wrong—the correct answer is 645 days!). If the test taker is exactly rational in constructing his ranges, he would expect to get 9 of the 10 questions correct.

In the dozens of times we have performed this experiment, the most common score is about three right answers out of ten. Usually the highest score in a group will be about six. The conclusion? We humans are over-confident in our ability to correctly guess things we do not know.

This has an obvious correlation for investors. Consider these other questions:

What will Apple's (AAPL) revenues be in fiscal year 2015?

How many employees will Facebook (FB) hire this year?

Where will the Dow Jones Industrial Average (^DJI) close at the end of next month?

None of us can know the answers, but we should be wary about how sure we are of our guesses, since we may be putting our money at stake on the outcome.

In this article we will look at the dangers posed to investors by over-confidence and four other psychological biases that each of us is prone to.

Over-Confidence
It's not just in trivia questions that we humans are over-confident of our abilities. There are plenty of other examples….. 68% of trial lawyers believe they will win their case, 80% of students think they will finish in the top half of their grade, 19% of Americans think they are in the top 1% in terms of household wealth, and on and on and on.

The lesson for investors? Make sure that your valuation of a stock is conservative, and then go a step further and insist on a margin of safety from that value before buying. As the great Benjamin Graham has said, "In the old legend the wise men finally boiled down the history of mortal affairs into the single phrase, 'This too will pass.' Confronted with a like challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY."

Let's say you think a particular stock is worth $50 per share. Well, hold off on purchasing it until its market price is at a significant discount from that value. If 20% is a big enough discount, then $40 would be a good entry point. This will give you two benefits: (1) if your analysis turns out to be too optimistic and the stock declines significantly, you won't lose as much as you would have had you paid $50, and (2) if the stock's value continues to go up and the market eventually prices it closer to its true worth, you'll make even more than you would have had you paid more.

Anchoring

Here's another trivia question for you: Of all the nations in the United Nations (UN), what percent are African? Psychologists Daniel Kahneman, the winner of the 2002 Nobel Prize in Economics, and Amos Tversky asked this very question to their research subjects.

There's a catch, though. Just before asking the question, they spun a wheel of fortune that would land on either 65% or 10%. This number was completely arbitrary and had nothing whatsoever to do with the percent of UN nations that are African. Curiously, though, the median estimate of participants who received the higher arbitrary number was 45%, compared to 25% for participants who received the lower one.

This bias, known as anchoring, is the tendency to rely too heavily, or “anchor,” on a piece of information—often irrelevant—when making decisions.

Investors often anchor their investing decisions on the price of a stock, be it the purchase price or a historical price. An investor that has bought a stock for $10 per share may not want to buy the stock at a later date for a higher price, even if the company is still selling at an attractive valuation. That initial purchase price anchors the investor, clouding his judgment and preventing further analysis.

The historical price of the stock can also serve as an anchor. One may refuse to buy a stock today because it was cheaper last year; or, one may refuse to sell a stock because last year’s price was higher. But company-specific or industry-wide fundamentals may have changed in the meantime, making comparisons with those historical values irrelevant.

Vividness Bias

In the first few weeks after the 9/11 terrorist attacks, people were actually willing to pay more for a policy that would insure them against death from “terrorist acts” than for a policy insuring against death from “all possible causes.” The fresh memory of the events of 9/11 masked the fact that dying of “all possible causes” includes dying from “terrorist acts.”

This incorrect thinking is due to vividness bias, the phenomenon in which people tend to predict the frequency of an event based on whether a similar event has happened recently and is therefore vivid in people's minds.

Investors can get blinded by the vividness of recent performance in the stock market, causing them to be depressingly lethargic or irrationally exuberant. They tend to project the immediate past into the distant future. In fact, the amount of investor cash that flows into equity mutual funds is highly dictated by this mentality, which is akin to driving a car forward while looking in the rear-view mirror.

For instance, the single-largest year on record for additions to equity mutual funds is 2000, after the market had experienced significant advances. The next two years saw the market drop -12% and -22%. On the other hand, the single-largest year on record for withdrawals is 2008, after the market had suffered substantial declines. The market advanced +26% and +15% over the next two years.

Loss Aversion

Loss aversion refers to the tendency to strongly prefer avoiding losses to acquiring gains. Kahneman and Tversky have conclusively shown that the pain of financial loss is twice as powerful, psychologically, as the pleasure of an equivalent gain. In other words, to make up for the psychological pain of a $1,000 loss, one would have to gain $2,000.

In investing, loss aversion can have a powerful influence, often to detrimental consequences. Oftentimes, investors continue holding a stock that they do not have much confidence in until they "at least come out even." If one adds these losses to the profits that might have been made by re-investing those funds when the mistake was first realized, the cost can become significant.

Commitment & Consistency

As psychologist Robert Cialdini has pointed out, people who make a written or spoken commitment to do a certain thing are prone to do that thing even when the incentive for doing it has been removed. Unscrupulous car salesmen are infamous for taking advantage of this tendency. If they can first get the customer to verbally commit to buying a certain vehicle, then the customer will be less likely to put up a fight during the negotiation process when the price is raised or unnecessary bells and whistles are added.

Even the great Warren Buffett himself has admitted to falling victim to the commitment and consistency bias. After he bought Coca-Cola (KO) stock in the late 1980s and early 1990s, the stock surged to more than $80 per share in 1998, with a sky-high P/E ratio of around 50. After his purchase, Mr. Buffett often spoke and wrote admiringly of Coke, and he sat on its board of directors. These actions caused him to be overly committed to an investment which, by all rights, he should have sold. It subsequently tumbled to as low as $40 and has never seen $80 again since that time.

Final Thoughts
While we are all susceptible to these five cognitive biases and the dozens of others we don't have the space to go into here, we can become better investors by being aware of the powerful influence they can have when we make investment decisions.

So before you buy that one stock you've had your eye on lately, or sell that pesky laggard from your portfolio, think twice about how you may be biased in your thought process.

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