From the Fund Manager's Desk

"Investing Without Biases" – *Feb 2021*

The value investing guru Benjamin Graham famously said in his book "The Intelligent Investor", "To invest successfully does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding the framework."

While the intellectual framework isn't hard to build in investing, what fails investors time and again is the emotional corrosion to the framework.

Even the most hard-headed investors go through times when they act (or not act) irrationally only to regret their actions (inactions) later. Some of those irrational decisions can be explained by the investor's own circumstances while the majority of the others are due to pre-formed biases that are hard to let go of. Most human beings naturally fall prey to these and aren't even aware of this! We will try to walk you through these biases and how you can build a framework to prevent them from upsetting your investment journey.

Confirmation Bias

Confirmation bias is the investors' limitless belief in an idea that holds them from considering alternative views. For example, when an investor is convinced about the markets going up, he would look for information that only cements his belief and turn a blind eye to data and analysis that indicates otherwise. The confirmation bias can prove most costly when the stakes are high, such as in a concentrated stock investment or a highly leveraged bet.

In the 2007 bull market, many investors were buying real-estate and infrastructure companies solely based on the premise that India will need tremendous infrastructure spending going forward. The confirmation bias was so strong that investors chose to overlook the glaring red flags like highly leveraged balance sheets of companies in the sector, cash-flow mismatches, and questionable governance practices of promoters in several companies. Naturally, many of those high-flying stocks fell more than 90% in the years that followed.

Loss Aversion Bias

Losses are an inevitable part of all kinds of investment strategies in risky assets. For newbies, losses are also the most unplanned part of their investment strategy. Generally, investors value profits much lesser than the pain they feel for losses, which is why they often take small profits and let losses run, which is quite contrary to how one should approach risky investments. Due to this loss aversion bias, investors take to lowly fixed deposit returns and shun the stock market due to its volatility and frequent mark to market losses, despite the evidence that equities have delivered much better returns than the FDs over long periods.

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Recency Bias

Recent events always have an invariably large bearing on our investment decisions. If the recent event was a market crash, investors will mostly sit out, and if it's a rally, investors will rush to invest full-throttle! Investors extrapolate recent events into the future and sometimes pass on the best opportunities. It's not only the small investors that get carried away, recency bias affects the smartest of investors as well. The pain and the excitement of recent events impair investors' objectivity.

For example, in the 2020 market crash, the market fell violently for a month in March, made a bottom, and saw a sharp recovery from April onwards. However, many investors kept waiting on the side-lines due to the terror of the COVID induced fall, despite mouth-watering price levels, and missed out on a once in a decade opportunity. Once stock prices ran up, investors kept waiting for another fall, which never came, and has kept several investors out of one of the most rewarding bull markets in recent history.

How does one avoid major behavioural biases in investing?

Build Awareness

The first step in anybody's investing journey is knowing yourself. You cannot eliminate biases. We have biases of all kinds in our daily lives. Everybody has them. One must build knowledge about these biases and the repercussions that can result from a lack of awareness of such biases.

Have a process and stick to it

All successful investors always have a plan that suits their investing style and risk appetite. Even with a plan, your biases can hijack your investment process and lead you to make mistakes. It's important that you stick to your planning.

For example, investors that have committed to equity SIPs and stuck to them over the last five to six years have seen periods of unmatched volatility during demonetization and COVID-19. Despite this, investors have generated handsome returns. Had they fallen for their biases and cancelled their SIP's, their returns would not have been as attractive as they are today. Executing your plan is important and rewarding.

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Our emotions can make us horrible investors. There's some comfort in knowing it's not just you and me, nearly all of us make some terrible decisions. The reality is that humans aren't wired to be great investors.

Now that we have been introduced to various biases, ask yourself as to what degree you've fallen victim. It's a great beginning point for smoking out your own personal weaknesses and becoming a better investor.

In the end, we leave you with the story of Jim Simons, the legendary money maker, who, from 1988-2014, delivered 66% average annual returns in his Renaissance Signature Medallion Fund, through a data-driven, algorithmic approach of investing, that swept the world.

In his book, The Man Who Solved the Market, Zuckerman, writes, "Simons and his colleagues believed that investors are prone to cognitive biases, the kinds that lead to panics, bubbles, booms, and busts. Investors act more irrationally than assumed, repeatedly making similar mistakes, overreacting to stress, panicking and making emotional decisions." "Renaissance's entire premise was that human actors will react the way humans did in the past and they learned to take advantage."

Simon's firm earned more than a whopping $100 billion in profits exploiting investing biases. How's that for a man who never even read a balance sheet?

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