How to stop making investing mistakes: Rewire your brain

As investors, we don't generally like to admit this, but we make mistakes. The issue is not the mistakes themselves, rather that they happen systematically, and that this results in mispricings in the market. While mispricings create opportunities for investors, it can be difficult to realise the benefits.

Most mistakes are behavioural. As humans, our behaviour has evolved over thousands of years, making it difficult to break free from nature's programming. Recent research has shown that our brains are plastic [1] meaning that we can make physical changes to our brains in order to override some of our worst pitfalls. Brain plasticity has shown to help stroke victims as well as treat a range of mental health issues.

At Kempen, we believe that what can help stroke patients can also aid us as investors. However, in order to rewire our brains, we need be aware of when we make mistakes, correct the faulty logic and replace it with rational thinking. This is a challenge – in investing, the notion of becoming perfectly rational is impossible, but we can improve by correcting the most common pitfalls.

We believe the most common pitfalls are an overreaction to news, an aversion to uncertainty and herd behaviour.

OVERREACTING TO NEWS

In general, people assign more value to recent information than the distant past. From an evolutionary perspective, this makes sense: running away from immediate danger would save your life, whereas thoughtful contemplation of the long term consequences of running away instead, would likely not have the same result. In the context of financial markets, we tend to overvalue the importance of short-term information, which can lead to markets overreacting to short-term data [2]. A good example is a company issuing a profit warning. Negative news comes out, and our tendency is to run, just like in the previous example. This tendency, however, creates opportunity as the market becomes overly worried about the prospects of a company. As an investor, buying a portfolio of these types of companies can result in long-term returns significantly better than the market. Executing on such a strategy is more difficult, however. We believe the best way to overcome our own behavioural bias is to focus on long-term information, which puts the profit warning into context. Often a profit warning is seen a permanent mark on a company's profitability, where in reality it is often only the result of fluctuations in the business environment.

By focusing on the long-term value of the business, it can be possible to benefit from a profit warning. Over time, this can rewire your brain to be less susceptible to short-term information. While overemphasising short-term information is bad, it is worsened by our aversion to uncertainty.

UNCERTAINTY AVERSION

Our brains evolved in an environment where uncertainty did not pay off. Acting on every threat, whether real or not, increased your chances of survival. This resulted in an aversion to uncertainty. While accepting that uncertainty in nature was not a

[1] Norman Doidge, The Brain That Changes Itself: Stories of Personal Triumph from the Frontiers of Brain Science (Penguin, 2008).
[2] Werner F. M. De Bondt; Richard Thaler, 'Does the stock market overreact?', *The Journal of Finance*, Vol. 40, No. 3, Papers and Proceedings of the Forty-Third Annual Meeting American Finance Association, Dallas, Texas, December 28-30, 1984. (Jul., 1985), pp. 793-805.

good strategy for survival, it can be in the stock market. The market discounts uncertain outcomes, and assumes that every perceived threat will become reality.

This results in an uncertainty premium, which is difficult to exploit, but not impossible. In order to do so, you need to accept that some outcomes will be negative and therefore diversify across different companies to capture the uncertainty premium. Combining diversification with a margin of safety means that your actual risk of losing money can be low. Buying stocks at a large discount to their fundamental value gives investors room for error in case the outcome is negative. If a stock is cheap enough, a negative scenario may still result in a positive return.

By consistently applying this framework, we can become adapted to accepting uncertainty. Our brains learn that the overall outcome is better than sticking to more seemingly certain results. Uncertainty is difficult to accept, and is intensified by our last behavioural pitfall, herd behaviour.

HERD BEHAVIOUR

Another logical strategy from an evolutionary perspective is herd behaviour, as survival was higher in groups, which made us more comfortable acting together instead of alone. Our behaviour in stock markets reflects this legacy. We prefer to buy the stocks that are popular, the ones that everyone's talking about and tend to avoid what has done poorly. Doing the opposite is emotionally challenging because it can feel lonely, although contrarians make a feature of going against the crowd. This creates mispricing as the crowd overprices what is popular and underprices what is not. At Kempen, we see group behaviour as one of the reasons the value premium has existed for as long as it has. We believe the best antidote against financial groupthink is to understand past cycles. By reading about past cycles, we learn that history really does repeat itself [3].

Other than understanding financial history, we believe anchoring to intrinsic value helps to reduce groupthink. By focusing on the fundamental value of the business, the crowd has less impact on your decision-making.

IN CONCLUSION – REWIRING OUR BRAINS

Contrary to popular belief, our brains are plastic. This means we can rewire our brains by consistently applying a more rational thought framework. As investors, we can apply brain plasticity with the aim of reducing the number of mistakes we make. By focusing on long-term information, accepting uncertainty and anchoring to intrinsic value, we believe many of the biases can be reduced.

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[3] Norman Doidge, The Brain That Changes Itself: Stories of Personal Triumph from the Frontiers of Brain Science (Penguin, 2008).

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