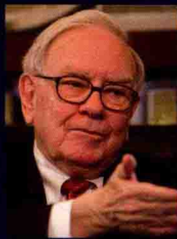

COLIN NICHOLSON

THINK LIKE THE GREAT INVESTORS

MAKE BETTER DECISIONS AND RAISE YOUR INVESTING TO A NEW LEVEL

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The best investors succeed because they seem to think counterintuitively. They make better decisions by avoiding the common cognitive biases, which are natural to us all, but that hold us back in our investing. Learn how the great investors think and raise your investing to a new level so you can join the winners' circle.

For Tony Featherstone

who commissioned my articles for Shares *magazine*

About the author

Investor, author and investment educator Colin Nicholson has a bachelor's degree in economics from the University of Sydney and a Graduate Diploma in Applied Finance and Investment from the Financial Services Institute of Australasia (Finsia). He taught both fundamental and technical analysis for Finsia for many years and was judged Outstanding Presenter for 1997 by student feedback. In 1995 Finsia made him a Senior Fellow. Colin is a past national president of the Australian Technical Analysts Association, which made him an honorary life member in 2001.

Colin has invested in stocks on the Australian market since the late 1960s while employed in sales and marketing in the food, brewing and paint industries. Since April 1987 he has been self-employed, earning his income from investing, supplemented by writing and teaching. He is a popular speaker at conferences and member meetings of the Australian Investors Association, the Australian Shareholders' Association and the Australian Technical Analysts Association.

Colin does not sell anything except his books and his writing on his website www.bwts.com.au. This book builds on the idea that winning investors think differently, as discussed in his book *Building Wealth in the Stock Market* (originally published as *The Aggressive Investor*), which sets out his investment methods.

Important note

This book has been written for the sole purpose of teaching investment techniques. It neither purports nor intends to offer advice to any reader to invest in any specific financial product or to use any specific investment method. Readers should not act on the basis of any matter in this book without considering their own particular circumstances, taking professional advice where appropriate. Past performance should not be regarded as evidence that any particular method will be profitable in the future. The decision to invest is for the reader alone. The author expressly disclaims all and any liability to any person, in respect of anything, and of the consequences of anything, done, or omitted to be done, in reliance, whether whole or partial, upon any part of this book.

Colin Nicholson is not a licensed investment adviser. He does not give either specific or general advice as defined in legislation.

Colin's methods have been developed to meet his financial objectives and to be consistent with his level of knowledge, experience and risk tolerance. Readers should regard his work as a model in developing their own investment plan.

The core articles that make up the chapters of this book were originally published in *Shares* magazine. Other chapters are expanded versions of articles written for *AFR Smart Investor* magazine and published in Colin Nicholson's newsletter and on his website www.bwts.com.au.

All chapters have been extensively revised and arranged to provide a basic introduction to common decision-making errors that adversely affect our investment returns.

The chapters in part I now have a section suggesting strategies to manage the cognitive biases described. The addition of strategies provides a practical guide to better investment decision making.

Contents

PART I

Stretching our mind

Man's mind stretched to a new idea never goes back to its original dimensions.

Oliver Wendell Holmes

Most of us have learned to make decisions in a haphazard manner based on doing what comes naturally. However, research in the new field of behavioural finance has shown that our natural instincts often do not serve us well. Once we are introduced to the common cognitive biases in the way we make decisions, we will never look at the investing process the same way again.

Chapter 1

Shaping our destiny

It is in your moments of decision that your destiny is shaped.
Anthony Robbins

I am a very keen reader of books and articles about investing. In particular, I love reading about the great investors, those who consistently achieve outstanding returns that make them and their clients very wealthy. After all, if we want to be better investors, our best models are those with a proven outstanding track record.

The more I study the great investors, the more I am struck by the way the quality of their thinking seems to be superior to that of the ordinary investor. I find that the great investors have several key attributes that, in combination, lead to outstanding results and to their classification as outstanding investors:

- *Education.* This is a must. A very few have been entirely self-taught, but most will have a tertiary qualification, usually at postgraduate level. Moreover, they maintain their level of education over their career in all sorts of ways, both formal and informal.
- *Intelligence.* They tend to be of above-average intelligence but do not have to be in the genius class, which can, in fact, be a handicap.

Modern finance is not easy to understand and conceptualise. It requires a great deal of deep thinking over many years.

- *Experience*. Great investors do not just burst onto the scene. They ripen over time. They develop a great depth of knowledge about how markets work and what has happened before and have honed their skills under pressure in the markets.

Out of all this, the great investors seem to learn to think in ways that are quite different from those of the average person in the street who is trying to invest his or her savings.

When I read about decisions great investors had made that led to their investment success, I found that their decisions often seemed to be counterintuitive. This puzzled me for years. Warren Buffett, one of the greatest investors of my lifetime, started to help me put my finger on it when he wrote in his famous preface to Benjamin Graham's investment classic *The Intelligent Investor*: 'What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework'.

For a while I thought this was the key I had been looking for: to master the market we have to learn to master ourselves. It seemed that the solution was to be so coldly logical in every decision that I shut out my emotions by the sheer power of my logic. However, while this was a part of the puzzle I was grappling with and was a big step in the right direction, it was very difficult to implement and did not seem to provide the solution that I was seeking.

What still puzzled me was exactly what my emotions were and why decisions made by the great investors, which I read about, seemed to be counterintuitive rather than simply logical. Then one day the light came on for me. I came across what is called behavioural finance or behavioural economics. What I was calling emotions were in fact a whole set of cognitive biases in my thinking.

Since 1971 a tremendous amount of research has been done into the way people make decisions. As an economist, I was trained to assume that people always made decisions to logically maximise their personal gain in whatever situation they were in. From the research that has become behavioural finance, I have learned that people are far more complex than that and in fact do not always maximise their possible gains in investing or in life generally.

Instead I found that, when faced with a decision about something, we use shortcuts or *heuristics*. A heuristic is a rule of thumb for solving problems. For example, if a married couple are both blond-haired, we assume that their children are likely to be blond. Quite frequently these kinds of heuristics will be reliable guides and we will make sound decisions based on them. This is likely to be even more so when the heuristic is founded on experience formed over many situations over many years and becomes intuition. This is why experience is so important in investing: we develop intuition-based heuristics that avoid the common cognitive biases we are seemingly born with.

However, common heuristics and intuition that are not always well based on experience can lead us to make very poor decisions, because we are all prone to a wide range of cognitive biases when we make decisions. The Nobel Prize winners who began this new field of study have provoked wide-ranging research, which has meant that I have greatly improved my decision-making methods.

I began to study the cognitive biases that had been explored in the research and time after time I found them in myself. More importantly, I found that they began to explain the apparently counterintuitive thinking behind the decisions made by the great investors who I read about. Gradually I came to realise that their counterintuitive decisions could often be explained by the fact that they avoided many of the cognitive biases to which we are all naturally prone. This was partly because they had developed better intuition from the depth of their experience, which was greater than that of inexperienced investors. However, it was more than that: they also seemed to have developed an awareness of, and an ability to avoid, many common cognitive biases when they made decisions.

As a result of the pioneering work of the behavioural finance researchers, there is now a body of knowledge that can give us valuable insights into the task of making investing decisions. Many of these ideas were quite challenging to me at first, as they will be to you. However, once I became aware of some of the common cognitive biases in my thinking, I began to make better investment decisions and my returns began to improve. Not only that: I also saw the cognitive biases in my own thinking and that of others around me in all facets of life.

Decision making is right at the focal point of investing. No investment exists until we make a decision. No investment is successful unless we also make a series of sound decisions in managing it. We make the best decisions when we understand what is happening inside our minds and avoid the natural cognitive biases to which every one of us is prone, but which the great investors seem to know how to avoid.

My personal aim is to keep honing my thinking skills in order to come closer to being a great investor. How close I come is an unfinished story.

I have stressed two things in this description of my journey to writing this book:

- The common cognitive biases in our thinking are very natural. They never feel wrong to us.
- We are all prone to these cognitive biases to a greater extent than we imagine. It is not a criticism of us; it is just how we are made as human beings.

I have found that the initial step to dealing with our cognitive biases in investment decision making is to become aware of them. It is not until we know they exist that we can recognise them and start to deal with them. Therefore, a large part of this book will be devoted to a description of the various cognitive biases that can be present in the way we make investment decisions.

I have also gradually developed strategies for avoiding and countering many of these cognitive biases. These will be described after I have introduced each cognitive bias in our thinking in part I. Many of the strategies are effective in countering more than one cognitive bias, so some of them will appear several times, perhaps with a different emphasis.

I hope that having these strategies to work on will offer a roadmap to follow on our progress to becoming great investors. I invite you to join me on the journey.

Chapter 2

Men and women (overconfidence)

Most people have a lack of respect for economists. This partly derives from the basic assumption that underlies classical economic theory. The world that economists study is very complicated. The modern economy has a great number of moving parts, each of which interacts with the others. So there are a huge number of relationships to deal with. Moreover, these relationships change dynamically over time. Economists still struggle even to come close to building an accurate and complete model for how a modern economy operates, let alone have the computational power to run such a model to try to predict what will happen if we change some policy or other.

In order to try to understand the economy at a minimally useful level, classical economic theory was based on an assumption that mankind was totally rational in every decision made. Economic theory assumed that, when faced with a decision, we have all the facts, can weigh them up accurately and will always make a rational choice that maximises the (usually monetary) value to us. This led to the development of useful theories about how the economy worked.

However, anyone who has ever thought for a moment or two about what people actually do, and what they themselves actually do, will realise that these assumptions were bound to limit the usefulness of these theories. They were useful as far as they went, but they were not looking at the real world. We rarely have all the information. We have great difficulty weighing up all the issues. We most definitely do not act perfectly rationally every time. We all make some decisions impulsively and emotionally. We are all prone to cognitive biases, and we often make our most important decisions in a less than optimal manner.

In recent decades, this has led some researchers to study the way people really make decisions, rather than relying on the old theoretical models. They study how people actually make decisions, rather than assuming they always decide in a perfectly rational manner. Their work has helped to uncover the highly complex and chaotic system that is reality. It has also enabled us to recognise and understand the cognitive biases we are all subject to in making decisions. Out of this has come an understanding of how we can improve our decision-making skills by managing these cognitive biases.

This new field of study is called behavioural finance. It has probed into how we behave in a wide range of situations, including how we determine a price for something and how investors behave in stock markets. In the stock market, they carry out this research by observing and measuring exactly what people do and assessing the results they achieve.

One study by Brad M. Barber and Terrance Odean examined the trading results for 78 000 accounts at a large US discount broking firm from 1991 to 1996. A discount broker was chosen because it was far more likely that their clients were making their own decisions than at a full-service broker, where they would be acting on advice from a broker/salesperson.

The performance of the 78 000 traders was measured against the benchmark return that would have been obtained if they had done no trading over the year, but just held the stocks they had at the start of the year for the 12 months. The results indicate that they would have been better off not trading at all, because their start-of-the-year portfolio would have performed on average 2 per cent better than they actually achieved from trading. Table 2.1 summarises the results.