IFB253: Four Investing Biases and How to Overcome

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have episode 253. Today, we thought we would talk about maybe some soft skills involved around investing, we thought we would talk about some of the biases that can hold us back from becoming better investors, or maybe even encouraged us to become better investors. And there's four of them that we have not talked a lot about two of the ones that we've talked a lot about, and in particular, is confirmation bias.

And Andrew and I have both talked a lot about that. But we thought we would, we would focus on four other ones that maybe don't get as much acclaim as something like confirmation bias. So Andrew, I'm gonna turn it over to you and what you can start talking about the first one, and then we can just kind of start rolling from there.

Andrew

0:45

Okay, so I'm just gonna pick one from the list here. All right, I think it would be interesting and talk about Halo Effect, particularly because I find myself subjected to this with my stocks. So it's something I can always work on. The idea of the halo effect, is that I think it's mentioned, just like, in general, like, if a person succeeds in one area, then you tend to assume that they're good at everything. But another example I saw was Apple, which was to say that because their iPhone is so great, you automatically assume that their air

pods are great. So it's you like assign these positive qualities to something because you already liked that something or somebody. And I think Apple is actually a great example of that.

Because if you use Apple products, then you're probably going to feel pretty good about the stock itself. And while it's good to be inspired, and to invest in things, you know, and things that you like, that could be a slippery slope, if it's causing you to make decisions, the tough decisions you should be making, because investing and emotions don't always play well. And sometimes you need to make the hard decisions with the stocks, you know,

Dave

2:01

when you think about some of the I guess, more probeer logo slash brand type companies, of which Apple would definitely fall into that category. If you think about Netflix, you think about Starbucks, you think about Nike, maybe Coca Cola, I'm sure there's other ones out there that I'm not thinking of, but you, if you naturally love one of their products, you would you're going to associate good feelings with their other products. And likewise, think that that's going to be a great thing. And none of those companies are bad companies, and certainly not disparaging any of them.

But if you love Coca Cola products, then you're going to love everything that coke does. And likewise with Netflix. And, you know, that doesn't mean that they're good or bad investments. And Starbucks is one that I think, you know, if you try to take away people's Starbucks addiction, you might get, you might get lynched. And so it's, you know, people were very passionate about some of these things. And so it's very easy to correlate how much you love Starbucks coffee, to thinking it's going to be a great investment, and it could be in it could not be. But that's what, where these biases come into play. Because they, in essence, I always think of them as blinders. Like, you look at old school pictures of horses, with these, you know, pieces of material, covering their eyes, so that they can't see one way or the other, they can only see straight ahead. And that's what I was thinking of when I think of these biases.

And halo effect is certainly a bias that we can all attribute to, to different companies. And it's something that I struggle with as well. Arjun is a company that I've invested in, and I've been involved with them for almost two years now. And I love the company. I love everything they do. And so I naturally assign a halo effect to the CEO, Peter. And that's a very common trait. If you really like a company, you also assign these positive characteristics to the leader of the business. And I think you don't have to go too far to look at see how much the halo effect has impacted investors regarding Tesla. And likewise, Berkshire Hathaway, you

know, Warren Buffett is definitely the I have a halo effect with Warren Buffett. There's no question about that. And it's something that I have to keep in mind when I'm investing.

Andrew

4:15

I like that you mentioned those examples, because I certainly feel that way about Elon too. He's actually pretty charismatic, if you've seen some of his longer form interviews. And what he's done with Tesla has been nothing short of extraordinary. And it's funny because he has other projects like neural link, which scares me like you wouldn't believe and I don't get nearly as upset about it because it's Elon, right, as I feel like I normally would be.

That's definitely something to keep in mind. So how would an investor avoid you know, since you and I like to talk about picking stocks a lot? How do investors avoid the halo effect when they're picking stocks? Well, what have you found that you use to fight against That,

Dave

5:00

I think there's two things for me one is being aware that this is a bias, and that it's a bias that I struggle with. So just having that awareness helps me counteract it a little bit. The other part of it too is I go back to Charlie mongers idea of invert, always invert. And I try to, I try to always think of the downside, I try to look at the, you know, the dark side of investing in a particular company, and what could go wrong. And by reading bearish reports about the business or thinking about the risks, and what those could potentially entail for a company. I think that helps me offset the halo effect to a certain extent, it probably doesn't eliminate it completely. But it certainly I think, helps me offset it. What about you,

Andrew

5:49

for me, it's really I have to, I have to stick to the numbers. And I found that works for me really, really well in handling all sorts of biases. So I'll take Apple because I started with that example. As a full disclaimer, I own Apple, I've got it as one of my bigger positions, and I'm very bullish about the long term of the company. The way I've fought halo effect bias on both accounts is, first off, you have to be careful that a stock that you're buying, you're not paying too expensive of a price for it because you love it so much.

And so that's where a valuation model, like a DCF, or discounted cash flow model is very, very helpful for that. Because it exposes how much excitement you are baking into the price. So it keeps you honest, where at least it's holding the mirror to your face to say, Hey, you're expecting 10% growth, okay, like the DCF explicitly shows you that so you can't fool yourself about that part. So that's the first I guess there's include the third one because there's something that ties in the second one is the company's ROIC, which is another number. So I can believe all I want about the company's business model. But when I look at their ROIC, and I know how good it is compared to every other company out there, that tells me that a lot of things can can happen with that company. And as long as that doesn't go in the wrong direction, I know that they're compounding their capital for me, and I'm getting a lot of that back. And then the third aspect of it, which I guess would tie in with the first two is what's the average of outcomes in the business world or in the stock market?

So I talked about, you know, can you expect 10% growth? Well, what's the average growth you can expect from a company? Is it 20% is a reasonable expectation is it 5% Is the reasonable expectation. I'll tell you right now, it's somewhere close to the middle of that. So having the right expectations of where a company will do, I think is a good way to remove the halo effect, because you're basically just putting the odds on your side. And I look at the same way with ROIC where they have such a higher ROIC than the average. Which makes me feel good about the fact that I chose this company to invest in, because I know that the numbers clearly say that they are super capital efficient compared to a lot of other businesses.

Dave

8:24

Yeah, that's great. Those are great. Those are great techniques to use to overcome something like that. That's awesome. Using numbers and sticking with assumptions and reasonable ideas, I think is a great way to go.

Andrew

8:34

Which effect would you want to tackle next?

Dave

8:38

I think let's talk about maybe, maybe we could talk about two of them kind of in tandem, because I think they're kind of related. Let's talk a little bit about recency bias and hindsight bias. And I think, to me, they

kind of are related. I may be wrong as far as that exact terms. But to me, they're correlated recency bias to me, is when you extrapolate returns based on what you think happened just recently, whether it's good or bad, and kind of extrapolating everything forward.

Perfect example, Netflix, Netflix had, you know, a couple quarters ago now I think, had a air quote, bad quarter, where they didn't hit their numbers with their subscriber rates, which I don't think we really should have been much of a surprise to anybody considering they were coming off of what happened during the pandemic, and I guess, unreasonable expectations for that kind of growth to continue. And the stock got hammered. And I think everybody since then thought, Oh, God, this is a terrible stock. But then if you look at the return, since that happened, it's up like, I don't know 50 or 60%, since that happened, and so, you know, if you're just looking at what happened recently, you would think Oh, terrible investment. There's no way I could ever buy something like like Netflix, but it because the company is, you know, continued to perform since that happened, it's done well.

But I think it just shows that sometimes we get so caught up in what happens recently, whether it's good or bad that we just extrapolate that over a long period of time. And that can really harm your investing process if you just focus on one quarter, or a very short period of time, because over the long term, the stock market is going to return nine to 10%. And if we just focus on what happens now, it's, it's kind of like one of those things where you zoom in on a chart, and you see all the jagged edges. But then if you zoom back, you see the smooth growth. And that's what really matters. And I think recency bias to me is all those jagged edges, because you're you're so focused on what happened yesterday. And I kind of feel like that hindsight bias kind of falls into the same idea where you're projecting all the future growth of the company and what they've done in the past. And, you know, the companies all say, and all their financial reports that, you know, past results do not guarantee future results.

And I think it's very common for us to go look how great Coca Cola did in the 1980s, it's still going to happen here. I'm not saying it's not but just as an example, and same same idea with American Express, you know, what a monster company it was. Now look at it, look at GE and in the 2000s and 1990s, it was a beast. And now look at it. If you look at the hindsight of a company, and project that forward, that can really harm your returns as well, because you're not, you're not taking into account the quality, the business management, all those other characteristics that could impact the future returns of the company.

Andrew

11:43

Yeah, that's very well said. I mean, the problem with hindsight bias is you have to recognize when things have fundamentally changed. And I think it's going to be it's a very interesting time to be an investor right now, because we've gone through a pandemic, and then geopolitical, crazy geopolitical tensions are still continuing, and inflation that we haven't seen in decades. And that's not even including all the supply chain mess that's been ramping throughout the last 12 months. So it's one of those things where I think investors will, we tend to be slow to recognize when things have changed. And hindsight bias plays a huge role in that because we look back in the rear view, and we see things that seemed so obvious, like, I love that Netflix example, companies that did really well during the pandemic, zoom and peloton. peloton being good examples of that.

And it's easy to like dismiss that and say, Oh, well, they should have known that was temporary. But we forget, hindsight bias makes us forget what it felt like to be in that moment, where we really didn't know if things would ever get back to 2019 levels of people traveling and people going to the gym and things like that. So it's really tricky. And it's I don't know, I mean, because you could say, well, this is hindsight bias in one area. And then in another area. hindsight bias, could mean you'll be fine. A lot of companies that have done well, the last 10 years will continue to do well the next 10 years. So it's not a it's not as easy to identify maybe. And that's what can make it so destructive, because you can really trick yourself into thinking that you're not biased when you are. And so it makes it hard to fight.

Dave

13:35

It is very hard to fight. How would you bite against hindsight bias slash recency bias?

Andrew

13:41

I think I feel like it's a daily struggle. It really is. I feel like I'm blessed because I have you the to help me reframe my ideas a lot. Because I think that's important to have somebody to bounce ideas off and to keep you humble, from like thinking you have it all figured out. And even just like some feedback on an idea you might have can change your perspective on how you're thinking about something. And when it's a big picture thing that can really help you make better decisions.

So I wish there was like some easy prescription like we can say, like to use numbers, but in the case like this, I don't think there is you just have to, you have to stay open minded, but at the same time, you have to be closed minded enough to know what matters, because it's very tricky balance.

Dave

14:26

Yeah, it really is. And I think, you know, I appreciate the kind words I feel the same about you that I'm lucky to have you to help me reframe and keep me you know, keep me back on track when I start getting crazy and going hey, you know, that kind of thing. And it helps me refocus where I need to really be focused on because I can get too enthusiastic about things that are not realistic sometimes. And I guess the recipe if you will, is if people can find like minded people that they can interact with, that can help them use these kinds of, you know, traits and ideas to bounce ideas off of, or to give them a different reframing of a particular situation or an idea.

Those kinds of things can be very, very helpful social media, if you don't have friends that are into the stock market, that you can really discuss these things with them. There are social media out there that can help you with that. And the other thing that I guess that I always try to keep in mind, is just a constant refrain, kind of an endless loop in my head, has anything changed with the business? Has anything changed with the business? And I think for me, thinking of it that way helps me think about, okay, there's all this noise about, you know, company A or company B. But if I think about what they do, has that changed, and has the desire for what they sell, or do really change, like the public desire to have that like Apple, you know, the desire to have their iPhone, is that really abated? And it doesn't, it hasn't. And so that can help you stay on track and not get stuck in how well Apple has done in the past.

But focus also on the business now and what they're going to do going forward. And I think that can help offset some of the hindsight bias. But it's hard. It's you know, it's very hard to do those kinds of things. I think another thing that I think is helpful is journaling or writing down your investment thesis and coming back to it on a regular basis, can help ground you in why you really bought apple, for example, in the first place. And because sometimes our memories are not exactly what we think they are. And we can look back and go, Oh, I bought it because of this. But then you write it down. And then you look at it six months, a year, two years later, and you find out, whoa, that actually wasn't really the reason I bought it to begin with.

So I think that's something that can really help with with hindsight bias, or recency bias, is writing down your ideas. We had Jake Taylor on a while back, and he's the founder of journalistic. And just recently, he announced that that has now gone open to the public. So you can go to journal lytic.com. And it's a free resource that you can use to keep track of your ideas. And any sort of journaling that you want to do for anything, but really for investing. But you can do it for anything. And I think that would be a useful tool to help with some of these biases, because we don't always remember exactly the way things actually

happened. And time warps some of those things. And I think something like that would be very helpful, completely agree.

Andrew

17:30

And as a early adopter of that, I highly recommend it. I probably don't use it as much as I should. But no, I

Dave

17:37

don't either. But I do use it. And I love it. Yeah. Yeah. And it's free. So did I mention it's free? All right. All right. So the last bias that we have is the endowment bias. Would you like to tell folks about this fun little adventure?

Andrew

17:52

Sure. So it's basically this idea that we assign more value to something that we own than what it's really worth. And sometimes it can get to a point where it's irrational. And so how do you fight it? I mean, there was a great quote, org, and he said, it was Adam Smith, aka George Goodman. I don't know if that's true or not. But basically, the quote is, the stock doesn't know you own it. So we have to remember that when we're looking at our portfolio, because it's easy to get grounded on, okay, I bought the stock at $10. Now, it's at $15. This is an awesome company, or this is a great stock.

And just because that was a case for you doesn't mean that's the case for investors moving forward. And just because that stock has done well for you in the past doesn't mean it's going to do well for you the next five or 10 years. So it's another one of those tough things that you have to think about, Am I falling in love with this stock so much? Not even because it's good or has good qualities, but literally just because I chose this is my stock I'm gonna buy it is my idea. And so am I putting up those blinders and not looking at all the facts because of something that you own. And that's something that can be really dangerous, too.

Dave

19:14

Oh, extremely dangerous. And we were talking about this the other day fantasy football, when you think about when you go through the effort of picking your team, and assigning your team and every week you

feel like that you have done the best job that you can do and all these players are the best players. And you're we're always a little bit surprised at the end of the week when we don't win.

But then if you look at it, if you remove yourself from the situation and you just rank the quality of the teams based on whatever metrics, you know, maybe NFL football has, maybe they don't stack up that great but because we own them now said running back is the best running back in the league and said quarterback is the best quarterback in the league. When In reality, that may not actually be the case. And I think that kind of idea applies to stock picking as well. I mean, how many times have we or you or I fell in love with a company, and we bought it. And now we think it's the greatest thing since sliced bread. And, you know, returns and maybe the company performance, indicate otherwise. And so it can be, it can be really hard to really overcome something like that. It's not a bias that I think gets a lot of a lot of press. But it's certainly one that I think is very dangerous. And it's very, sometimes when the facts change, we need to change our mind. And when we buy companies, we ideally want to hold them for a long time. But sometimes the facts change, and we have to, we have to recognize that and decide whether we want to move on from that position.

Or if we want to consider reducing it or whatever it may be. But those are all things you have to keep in mind when you ever you buy any individual company, because nothing is forever. And ideally, we'd love it to be forever. And that's the idea when we pick a company, but the facts will change. And we have to change your mind with that. And I think that goes hand in hand with the endowment effect. Because it's so hard to overcome that, you know, hey, I bought, you know, I bought Pay Pal, it's a great business. And it's like, well, the market says otherwise their financial performance has been a so but because I own it now, I put more backing behind something like that, then maybe I should. And so those are definitely struggles that I struggle with, for sure.

Andrew

21:36

So how do we fight back against this endowment effect, because obviously, you can't just stick your head in the sand and just ignore these things and pretend that things aren't potentially changing.

Dave

21:48

I hate to sound like a broken record. But I think a lot of it comes down to knowledge of the business and understanding the business and keeping tabs on what's going on. Not necessarily that you have to follow every minute move that the company makes, but at least be passingly aware, every quarter that they've

reported earnings, and maybe giving a listen to the earnings call and maybe understanding if something in the business has changed. And, you know, let's say just for example, that you you bought the company that owns Olive Garden, and now all of garden has decided that instead of being Italian food, they're going to sell only breakfast items.

And that's it, well, that's a big change. And if you're not aware of that, that is going to impact the business. Now, it may not be, you know, life killing. But it certainly would be disruptive. And so those kinds of things we need to be aware of. And if something like that happens, then we have to be open minded enough to understand that when changes like that happen, then we have to decide what we'll be able to to adapt. And I think the other thing is going back to journaling is writing down the idea of why you bought the company and then reviewing that on a regular basis will help keep in mind why I bought this business. And if something has changed about that business that what they're doing or how they're doing it will have an impact on it. Perfect example is look at you know, let's say you owned AT and T and then Apple comes out well not in Apple BlackBerry comes out with their phones and an Apple comes out with their phones. Well, the way people use phones dramatically changed.

And so a TN T 's position in the marketplace would have changed drastically from that point forward. And so I think having a realization of why I bought a TN T to begin with. And now something has changed. If you don't have a record of that it might be hard to remember in the time when something like that occurs. And so for me, I guess it's those two kinds of ideas is the way that I tried to fight it. How do you work against this?

Andrew

23:50

I don't think I have like the perfect answer or anything. But this framework has been helpful for me. And I envision using some version of this for quite some time. But I've talked on the show before probably many episodes about how I have an automatic sell rule with negative earnings. So if we look historically, and you look over, let's say the past 20 years, you're going to have more of that during like a recession. But over that 20 year period, let's say maybe 10% of companies fall in that camp.

So okay, that's already 10% of my portfolio that I'm going to be selling, like, say every year. And then if you take another 10 to 15%. That's for me if I'm buying 12 stocks a year, so that's one stock a year I'd be selling. So I almost have this framework of I'm not gonna say that perfectly every year, but maybe I sell one to two to three stocks per year trying to maybe sell one discretionarily and one because of a cell rule. And so where that's putting my portfolio is like a 25% turnover rate, which is about a four year are average holding

period. So if you took your whole portfolio, you turned it over 25%, you'd have about a four year average period per stock. Doing that, it reminds me of a Steven keenness, I kill your darlings.

And, you know, some other companies, which they haven't succeeded since doing this. So it's like maybe not the best analogy, but I know GE in the past, they used to like cut the low 10% every year. But if you think of your portfolio in that way, at least when I started thinking of it in that way, now, instead of getting all defensive about like, all this stock, you know, they're putting up bad numbers, but it must be, you know, and I add an excuse here or there. It allows me to flip the narrative of like, okay, is this one of those darlings, I'm just gonna have to kill. And so I'm almost like actively looking for reasons to sell something down. And I think that's helped because it's, it brings a different mindset versus like, feeling like, every stock needs to be a winner. Instead, maybe 10% are losers. And I'll do much better by identifying those early, but I haven't stuck to that perfectly. And I'm like, really taking my time on discretionary selling out of positions.

But at least as far as finding the bias, I think it's helped because now, my mindset has shifted towards, alright, you well thing. Let's actually figure out what's going on. And, you know, you prove to me why I should keep you that helps me not feel so emotional about the stock itself. And remember, it is a stock and not like a family member or something.

Dave

26:39

Right. But it's it's so hard because there, we put a lot of time and effort into learning about these companies and buying them that they become, it becomes personal. And it's hard to separate that from fact and fiction. And so working against these different biases that we've talked about today can be an ongoing struggle, and I don't think you could ever conquer any of them or all of them. Would you agree with that? Yeah, yeah.

Andrew

27:07

It's a struggle for sure.

Dave

27:09

I think people that are headed towards less emotional responses to things probably, over the long term, become better investors. And I think somebody like Warren Buffett and Charlie Munger, I have a feeling they're pretty, fairly unemotional. And that probably goes a long ways towards how well they've done over

the long term in the market. But you know, they're human too. And they definitely fight against biases, just like everybody else does. All right, well, with that, I'll go ahead and get off my soapbox. And we'll go ahead and wrap up the conversation for today. I want to thank Imran batla.

I believe that's how we pronounce the name. I hope I did it correctly. If I didn't forgive me, sent me a great tweet on Twitter about this very idea. There was a great post about the 13 different biases Andrew and I thought we would pick out four of them to talk about today. So we really appreciate the feedback and the great idea. So without any further ado, I'm going to go ahead and sign us off you guys go out there and invest with a margin of safety, emphasis on the safety. Have a great week, and we'll talk to you next week.

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