


"Dad, please tell me a story, please".

Sound familiar?

We can all relate to the power of stories. Those that are told to us, those that we tell ourselves, and those that we tell others.

Stories simplify learning, understanding and recall. Stories can motivate us, move us or moor us.

I recently shared a car ride with my friend Stefan. As we drove from Boston to Cape Cod, I was pitching an investment idea. Half-way through explaining why I liked it, Stefan interjected and said; "Lar, just the facts please". This brought a smile to my face as Stefan and I have often talked about the dangers of coherent stories.

Stefan's request was a gentle reminder not to get blinded by the power of story, and it is the catalyst for this note.

Coherent Stories

We make decisions based on stories, not numbers. Can you remember the last time you made a decision based on a number?

Where no stories exist, we create them. Our brains love to close gaps and package things into neat stories. For most of what we need to do in life this 'gap-filling' works well as it preserves our precious cognitive load.

When it comes to investing however, we can be mis-led by coherent narratives and once we have them in our heads, we can be very reluctant to change them (status quo bias). Narrative fallacy and confirmation bias conspire to blind us to where we may be wrong.

*"All lies in jest, still a man hears what he wants to hear and disregards the rest"* (The Boxer - Simon & Garfunkel).

We frequently build beliefs based on insufficient evidence, **failing to appreciate that the plural of anecdotes is not evidence.**

"High-conviction" concentrated portfolio managers are particularly exposed to being captured by the power of story, especially if the story/thesis has been true for a long time (a historic compounder). We are sitting comfortably, blind to the impending tornado.

Possible Antidotes

There are two broad approaches to dealing with this problem; prevention & cure ("*an ounce of prevention is worth a pound of cure*") - what we might call the antidotes to the anecdotes (a.k.a. cures for stories).

**Antidote Category A: The Art of Prevention**

A.1 Slow Down

We don't have to be fast; we just need to be right.

Our minds tend to get excited about a positive thesis and discounts negative data when in such a state.

To this end we can force a cooling off period before making an investment. Take a few weeks or months and then re-visit the thesis. Our purportedly compelling idea frequently has warts on it. Better to move on and resume the truffle hunt. For truly great companies, being a few months late has negligible opportunity cost.

To help us slow down, we can use checklists which are rationally and honestly updated.

A.2 Cultivate a Scientific Mindset

Evolutionary biologist, Ernst Mayr put it like this:

"*All interpretations made by a scientist are hypotheses, and all hypotheses are tentative. They must forever be tested, and they must be revised if found to be unsatisfactory. Hence, a change of mind in a scientist, and particularly a great scientist, is not only not a sign of weakness but rather evidence for continuing attention to the respective problem and an ability to test the hypothesis again and again*".

As a discipline, science is robust at filtering out noise. Good scientists (those with 'scientific equipoise') strive to start out with no pre-conceived bias or prejudice. If predictions deduced from any given hypothesis are proven untrue, the hypothesis is rejected. When new information comes to light that is inconsistent with the established thesis, then that thesis must be rejected. Remember what Keynes did when the facts changed.

Rational investors think like scientists, not defence attorneys.

A.3 Check the distance from the Base-rate

When we make an investment, we are effectively making a prediction. It makes sense to test that prediction against pre-existing realities. For example, if I am investing in a capital-intensive business and I expect double digit net income margins, I should test that likelihood against what is normal (the base rate) for similar companies. The degree of confidence in my prediction should be inversely proportional to its distance from the base rate.

It's always sensible to be able to explain what needs to happen for our views to hold water. We don't want to be relying on six impossible things before breakfast.

A.4 Brain-splits

Edward de Bono has done a lot of practical work on how our brains work. His "Six Thinking Hats" framework forces us to differentiate between facts, opinions and feelings. For example, if a group of people are analysing an investment opportunity, the thinking hats approach would parse the discussion into distinct phases. The Black Hat phase covers risks, weaknesses & dangers. During that part of the discussion, everyone "wears" the Black Hat. Only when all the risks have been discussed does the group switch hats to another colour, for example to the Red Hat which deals with feelings. (White Hat covers facts, Blue Hat covers process, Yellow Hat covers benefits and the Green Hat covers creativity). This process of splitting the brain into parallel thinking by forcing everyone to work on the same track at the same time is very effective at making and understanding decisions.

I used to work for a gifted tax consultant who opened all his written advice with a paragraph titled "Facts as understood". Only from there did he move on to giving an opinion.

A.5 Different Roles

The classic analyst/portfolio manager distinction is helpful here as is having a devil's advocate.

Better still is to hear, and be able to understand, the view of someone who:

- genuinely holds an opposing view (as it is too convenient to discount the devil's advocate view);
- is someone we respect;
- has a different background from us; and
- is willing to challenge us.

A.6 Pre-Mortems

Credited to Gary Klein, a pre-mortem is the act of writing down what has gone wrong in advance of such a possibility. Assume that your prospective investment has failed miserably and write the news release of what went wrong. Better still, ask a few people to independently write a pre-mortem. This is not an exercise in outlining what *might* go wrong but an articulation of what *did* go wrong. The subtle shift engages a different part of our brain to uncover a wider appreciation of the number of ways in which things can and do go wrong.

The pre-mortem however can only stretch our imagination, it won't help us with the "unknown unknowns" and we need to be alive to the first signs of those.

A.7 Be Careful who you Listen to

Because stories are so powerful, we need to be careful about the stories we allow ourselves to hear. Avoid untrustworthy or unreliable storytellers or sources.

A.8 Contrary Articulation Bar

Don't allow yourself to conclude on a matter until you can perfectly articulate the contrary view.

As F. Scott Fitzgerald astutely pointed out; "*The test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function*".

Law students sometimes have to prepare for moot court without knowing which side they are arguing. We learn a lot when we truly seek to understand the other side.

**Antidote Category B: Remedial Actions**

B.1 "Find Joy in Changing your Mind"

Changing our minds is cognitively expensive and socially distasteful.

To be able to find joy in changing our mind is unconventional, yet powerful. If we can cultivate our personal philosophy as one where we genuinely find joy in changing our minds, we are in a sense using the power of story to hack the power of story.

This is the approach taken by Charles Darwin who genuinely got excited when he found any evidence that disagreed with his previously held views. On stumbling upon such evidence, he would immediately write it down to give it more salience.

This philosophy can be embedded over time through the practice of changing our minds more often and being open with others on why we genuinely find joy in doing so. We can build our own narratives as to why this is the case (for example it's always nice to be less stupid today than I was yesterday).

A practical approach here is to make the default assumption that, say, 20%, of what you believe on any topic/thesis is simply wrong and your ongoing quest is to find out which 20% and why.

B.2 Consider the Opportunity Cost

It is helpful to recognise that all decisions have opportunity costs. Not changing our minds can carry the opportunity cost of missing out on a better solution. Good is the enemy of great.

B.3 Clear the Decks

To counter the endowment effect, confirmation and status quo biases, we could occasionally sell our entire portfolio (or have it randomly forced upon us like forced annual leave). I don't mean this as an intellectual exercise of approaching our portfolio with fresh eyes 'as if' we didn't own it; I suggest we make the physical sale and start afresh. If we are worried about being out of the market while re-considering our portfolio allocation, we can temporarily invest the proceeds in an index fund pending reallocation.

The clarity brought about by an actual sale is real. On the few occasions where I have seen colleagues forced to temporarily liquidate a portfolio (e.g. for tax planning), they have never bought back the same holdings that they held before the forced sale.

Given the transaction costs, practically speaking this is probably something that should only be practiced infrequently, perhaps once every few years. (Furthermore, an external investor may see this as an expensive approach to mental discipline. Many of the approaches that people are comfortable taking with their own money are harder to defend when managing external capital, even when such approaches make financial sense).

In his book *No Bull*, Michael Steinhardt spoke about his occasional decision to close out all his positions when he felt the portfolio was not in sync with the market and that he would be better off with a clean slate. "*In an instant, I would have a clean position sheet. Sometimes it felt refreshing to start over, all in cash, and to build a portfolio of names that represented our strongest positions and cut us free from wishy-washy holdings*".

B.4 Automatic Stop-losses

If we can't overcome a bias (e.g. holding onto losers through loss aversion or endowment effects), stop losses are one way to deal with the consequences of our bias. We take the decision away from our messy brains and can always re-group later and re-instate the purchase. A variant I try to practice is that when something I own has fallen by 20% or more, I either add to the position or exit it entirely.

Automatic stop losses are simply a version of quant and rule-based strategies that are designed to keep some of the emotion out of investing.

Traders use stop losses, technical rules, or other overlays to protect their total capital base, caring less about changing individual positions and more about the overall result (it is fine to lose 60% of the time if the quantum of gains from the 40% of winning trades delivers a disproportionate gain).

B.5 Say Less

While we need to be able to articulate our thesis to test our reasoning with knowledgeable sceptics, we should avoid becoming an evangelist for any investment. Public declarations are harder to pull back from especially if you have had to defend a view in public. Blinkers go on (and stay on) when in defence mode. When we are lecturing, we can't be listening/learning. We become like the crocodile, all mount and no ears (https://fs.blog/2015/11/listening-learning-lens/).

**Conclusion**

There is a saying that we should never let the facts get in the way of a good story. When it comes to investing, we should never let a good story get in the way of the facts.

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