Chapter 4:
The Biggest Behavioural Pitfalls in Investing

4.1 Part 1: The Biggest Behavioural Problems

> "*The most useful and practical part of psychology—which I personally think can be taught to any intelligent person in a week—is ungodly important. And nobody taught it to me by the way. I had to learn it later in life, one piece at a time. And it was fairly laborious. It's so elementary though that, when it was all over, I felt like a fool. And yeah, I'd been educated at Caltech and the Harvard Law School and so forth. So very eminent places miseducated people like you and me. The elementary part of psychology—the psychology of misjudgment, as I call it—is a terribly important thing to learn. There are about 20 little principles. And they interact, so it gets slightly complicated. But the guts of it is unbelievably important. Terribly smart people make totally bonkers mistakes by failing to pay heed to it.*"
>
> Charlie Munger

The followers of Efficient Market Hypothesis (EMH) believe that the market is always efficient, and stocks always trade at their fair value. According to this group of investors, any changes in the fundamentals of a stock will immediately be reflected in the price of the stock, thus making it impossible for investors to outperform the market. However, based on Koon's study, this is not always the case. If the market is indisputably efficient, as advocated by the professors of EMH, there would be no chance for those successful investors like him to exploit any arbitrage opportunities, gain in price difference from stock investments, and beat the market in the long run. In actual fact, the majority of his wealth is amassed through the acquisition of substantial stakes in undervalued companies with massive profit growth potential, and the disposal of those overvalued ones with no or low profit growth potential in visibility.

It should be noted that irrationality, delusional optimism, cognitive illusions and other human emotions have been largely overlooked when people assume that the market is efficient. In fact, the volatility of the stock market is, very often, driven by the irrational psychological factors. It is human's uncontrollable emotions, biases, fallacies and false perceptions that result in the deviation of a stock's price from its real business value. And the market is mainly driven by greed and panicked by fear. Or put simply, the movement of stock price is very often dictated by human emotions.

Of course, the changes of facts, and fundamentals of a stock do play an important role in the movement of its price. But, without stock market participants bidding it up or selling it down, the price will always stay flat. For those investors who think that fundamental, and technical analyses (FA/TA) are the only knowledge needed to survive in the stock market, think again. Investing psychology is one of the subjects least studied by most investors, but extremely important in investing. It is also the area where the largest chunk of gains can be obtained from stock investments if we understand human psychology well. Stumble into the biases and mental pitfalls; on the other hand, will cost us a hefty loss in our investments. That is why Koon always advises us to spend more time on studying human psychology.

Below are some common behavioural biases investors always fall prey to in investing.

4.1.1 Allow Emotions to Take Over Rational Thinking

> "*Eighty percent of the market is psychology. Investors whose actions are dominated by their emotions are most likely to get into trouble.*"
> George Goodman (pseudonym Adam Smith)

People always allow their emotions to take over rational thinking and seldom use logical system to process information especially when they are in emotionally unstable state. This situation is commonly seen when people are in fear during bear attacks. When they are bombarded with noise, and mentally overloaded as price plunges, the risk level they perceive will be raised, and their faith is wavering, even though the facts remain unchanged. Their Amygdalae (according to the study of neuroscientists at the California Institute of Technology, Amygdala – two almond-shaped clusters of tissue located in the centre of the brain – is a part of the human's limbic system that supports the functions such as behaviour, long-term memory and emotional processing) will induce fear, thus causing them to be conservative, and ignore bargains. They will either avoid the stocks completely (even if the investments are clearly high probability bets), or dump whatever they hold until the feeling of fear subsides. The latter is akin to throwing the baby out with the bath water, and in this situation, value is completely ignored. The over-reaction of hitting the panic button at every Sen/Ringgit drop, and disposing all their holdings at dirt cheap prices is the reason why people always buy dear and sell cheap. And this problem is commonly suffered by people who trade very often.

On the contrary, people become irrational buyers when they are in greed, having the fear of missing out (FOMO), or in an extremely happy mood. They have a tendency to take higher risks, buy aggressively, and chase after hot stocks when they are in euphoria. This is more apparent when the market is on the rise, and when stock market pundits are painting a rosy picture of an industry. At the same time, the dopamine level in the nucleus accumbens of investors will be rising. It will subsequently induce reward-motivated behaviour, lead to euphoria, and result in people take a high-risk bet, and ignore danger, as the irrational impulses get in the way, and they become more optimistic about the future of the stocks. Over-optimism is one of the worst cognitive biases people always commit to in bull market. This type of optimism is a spontaneous one, and always results in share price shoots to the moon, as investors continuously bid up the share price. As you may recall, the moment before the Asian Financial Crisis in 1997, the market was filled up with over-optimism, and the KLCI shot up to 1270. Within 18 months, KLCI fell 76% when the bubble burst. The Asian Financial Crisis was an important historical event showing that market bubble was caused by psychological problems, and people overly reacted to both good and bad news. As I am writing this, many

steel stocks have been making new historic highs every week. Koon told me that the people he meets everywhere as well as the people he exchanges opinions with in forums are optimistic about steel-related companies' future. When he advised people to be cautious, as the oversupply of property in every city of Malaysia will affect the earnings of some steel manufacturers, a few stubborn commenters even asked him to shut up. According to him, this is a clear sign of allowing greed to take over rational thinking. When the companies report decreasing earnings later, their prices will definitely plummet, and this group of investors is vulnerable to a loss due to the oversupply problem.

"*Everyone has the brainpower to make money in stocks. Not everyone has the stomach. If you are susceptible to selling everything in a panic, you ought to avoid stocks and mutual funds altogether*."

Peter Lynch

4.1.2 Hate Facts, but Like Stories

"*Too many people buy stories or trends - they don't buy businesses.*"

Donald Yacktman

The human brain is hard-wired to understand stories better than data. Thus, people tend to favour stories more than facts. According to Jennifer Aaker, a professor at Stanford's Graduate School of Business, "*a story is a journey that moves a listener, and when the listener goes on that journey he or she feels different and the result is persuasion and sometimes action*." That's why stories have a powerful ability to affect human emotions.

However, in investing, allowing stories to influence our judgement may not necessarily be good for us. Many of the sensational stories created by the media are for viewership, and have no "nutritional" value to our investments. Unlike facts, which cannot be created or manipulated easily, stories, on the other hand, can be twisted to meet the objectives of manipulators. For example, some analysts would write a fantastic story about a firm, and capitalise on human greed to dupe gullible investors into buying the stock, even though the company does not have a good earnings growth potential, and many of its projects are low profit margin work, so that the analysts and their associates could take advantage of the market force to bid up the stock price to their price target level, and get to sell the stock at an attractive price.

In addition, analysts and media understand that common investors are easily falling prey to framing effect, a cognitive bias in which the outcome of people's decisions is influenced through the way a situation is presented. That's why they will write a beautiful tale of a business with framing effect embedded in the story to bamboozle naïve readers into buying the stock they or their clients intend to exit positions. For example, even if a company has started to suffer some financial losses

this quarter, and face some oversupply problem, the media may frame the situation positively by just highlighting the positive development of the company. They would frame it in a way that "despite the tough operating environment and uncertainty, Company XYZ managed to sustain its profitability for the current financial year, and the management is endeavouring to continue improving their operating efficiency. We envisage the future outlook of the business to be positive." Any intelligent readers who assess the company's profit growth potential from a business perspective, and study its financial reports should notice that the recent quarter's financial loss has been muted, and been replaced with annual earnings in the statement. Further, they should be aware that oversupply is a serious issue. In this case, clearly, the analyst or media is telling a story with some hidden agendas. If anyone gives the story the benefit of the doubt, he or she would be suffering a loss in the investment when the price drops.

In addition, we should take note of some groups of stocks with inherent beautiful stories. The groups of stocks I refer to include, but are not limited to, large capitalisation stocks (with a hope to thrive continuously), rapidly expanding companies (with a straight line extrapolation of earnings forecast), IPOs (with a hope that the companies can take a quantum leap in its earnings), ACE market stocks (with a hope that they will be transferred to the Main Board), high-tech stocks (with potential to get higher earnings multiple), and other thematic stocks (with the likelihood of their prices being pushed up). These groups of stocks are always found with many beautiful stories created to trick ignorant investors into buying them up. That is why people tend to love stocks that generally have good stories and to shun undervalued stocks with profit growth potential. Most of the blue chip stocks are relatively expensive currently, and tend to produce lower returns than value stocks, as the irrational Mr. Market has bid them up to an astronomical level without bothering about the risk and reward of the investments. Lo and behold, as I am writing this, Nestle is shooting through the roof and is selling at Rm 150, or P/E multiple of 57.3X. Koon told me that he is concerned about the over-bullish and overvalued problem of Nestle stock when he saw a lot of jubilant investors rejoicing and congratulating one another in forums everyday. They do not seem to know what the number signifies and the danger of bidding a stock up to an overvalued level. It actually implies that if the company were to pay out all its earnings to its shareholders every year, it will take the shareholders 57.3 years to recover the cost of buying the stock. If you buy a share of Nestle today, you can only expect an earnings yield of 1.75%. That is why hot stocks with beautiful stories always underperform promising value stocks.

"*The fallacy is associated with our vulnerability to over-interpretation and our predilection for compact stories over raw truths. It severely distorts our mental representation of the world.*"

Nassim Taleb.

4.1.3 Herd Behaviour and Follow Others Blindly

"*Frequently the crowd is mistaken because they are not acting on the basis of any superior information but are reacting, themselves, to the principle of social proof.*"

Robert Cialdini

Animals have a natural tendency to flock together as a group for security purposes and other self-interests. And just like animals, humans also like to live in a group and act in the same way. People feel insecure when they are going in the opposite direction that the crowd is moving. In the study of Amygdala, Gregory Berns, a neuroeconomist of Emory University School of Medicine, also discovered that "*social isolation activates some of the same areas in the brain that are triggered by physical pain*". In other words, following the crowd generally makes people feel emotionally safe, and avoid the feeling of pain.

In investing, humans also always exhibit herd behaviour. The reason why most investors always follow the crowd is that most of them do not have an independent point of view. They prefer to follow tips given by other people such as their close friends, relatives, stock brokers, investment bank analysts, columnists, and the so-called market "experts". In addition, they have the fear of missing out. They will rather be wrong than missing out on an opportunity to win together with their friends. They always believe that if everyone is buying the same stock, other people must know something that they don't. That is why market participants always chase after hot stocks blindly in a group. Even if some of them may sometimes go against the crowd, they are unable to stay firmly on the ground when facing peer pressure. They do not know how to handle the social pain and stress when being criticized by their friends. In the end, they succumb to the pressure.

As much as following the crowd makes investors feel safe, the herd behaviour will not help them make money in investing. It is impossible for us to achieve an exceptional result by following the crowd. Most of investing ideas shared by the group members are inferior in quality. Even if the investing idea that we follow is a terrific one, we can only expect an average outcome since the prize has to be shared by so many winners. Further, studies show that investors who follow the crowd buying in euphoria (usually when the market is at its peak), and selling in panic (usually when the market is at its trough) always end up with a disastrous investment outcome.

Also, we should be wary of any investment professionals who claim to have an ability to predict short-term stock price movements. If we buy or sell on their advice, we are literally trading blindly. Bear in mind that these professionals do not know the market movement more than anyone. They do not a crystal ball either. In fact, most of them underperform the market index – KLCI – more often than not. History

has demonstrated again and again that most economists too failed to foresee crisis arriving when the market was still in euphoria.

4.1.4 Impatience

"*Successful investing takes time, discipline and patience. No matter how great the talent or effort, some things just take time: You can't produce a baby in one month by getting nine women pregnant*."

Warren Buffett

According to Koon's study, most of the stock market participants are short-term traders who simply take a punt with short-term orientation, and without having an edge. They usually invest with a very short time frame – a day or a week. Many of them do not have the patience to wait for at least a year for their investments to grow in value. They get in and out; back in and back out of the market frequently when there is news or rumours about a company. Even if the stocks they hold are high growth stocks, when their investments show too little gain they would immediately cash out without waiting for the growth being reflected in the share prices.

Most of them do not aware that the cost of trading in and out actively is so expensive that it could reduce their investment return substantially if they do not control their behaviour. In addition, they have to pay a higher price for a stock since they are not willing to wait for the right time to buy it. Likewise, they will miss the opportunity to win big since they sell their stock too soon before the price reaches its peak. If you are a patient investor, and can empathise with market participants, you would get it at a fire sale price and sell it near its peak. Patience is the key to successful investing, but not many people realise it. That is why Charlie Munger always says "*the big money is not in the buying or the selling, but in the waiting*."

4.1.5 Hesitate to Seize Opportunity

"*You have to have the courage of your convictions. That's what you are getting paid for. This is the time when I really earn my money*."

Bruce Berkowitz

We always see people blame god (or fate) for not giving them any opportunity to make money, and to prosper. But, in actual fact, we always see people hesitate to seize opportunities when they are given chances to buy good stocks at fair prices. They have a proclivity to procrastinate when opportunities arise. When the stocks in their watch list meet their selection criteria, instead of scooping up the incredible bargains immediately, they hesitate and procrastinate. They waste time pondering over the companies' survivability, thinking if they should still buy the stocks, and calculating how much money they should allocate for the investments, and so on and so forth. Also, sometimes they will wait for the companies to show a few consecutive quarters of

earning growth before they are prepared to buy the stocks. Eventually, when other investors gobble up the shares, the value quickly vanishes into the thin air, and the opportunities are gone. That's why Buffett said in 2008 that "*if you wait for the robins, spring will be over*."

Another reason why people fail to grab opportunities is that they fall prey to anchoring bias. Investors always anchor their decisions to outdated analyses, all-time low, or all-time high, and their previous buying or selling price of a stock. For example, if a stock's 52-week low is Rm 0.50/share, most conservative investors would not be willing to buy the stock at Rm 0.70/share, even though the business is worth Rm 1.00/share (apparently undervalued), and it has a tremendous profit growth potential. They would still fix their target buying price at Rm 0.50/share – the price they had missed out last time. Likewise, people are very likely to buy a stock when it touches its 52-week low – Rm 0.50/share, even though its earnings have been decreasing, the value has dropped to Rm 0.20/share, and there is no reason whatsoever to buy the stock, which may put a dent in their portfolio. Another interesting finding that I discovered is that if people sold a fast-growing company at Rm 1.00/share a few years ago, it is very unlikely that they will buy back the stock at Rm 2.00/share even though the stock is undervalued.

Also, people are averse to loss, and hesitate to pull trigger after losing money in an investment. According to Kahneman and Tversky, "*the pain of losing is psychologically about twice as powerful as the pleasure of gaining*." Their self-defence mechanism will kick-in when dealing with the same stocks they have suffered some losses before, even though the stocks have a great upside potential. For example, after losing money in a stock a couple of years ago, some investors will hesitate to buy back the stock, even though the fundamentals of the business have improved, and the company has reported increasing earnings. Koon recalled that when he bought Eversendai in 2017, many of his friends advised him not to touch the stock, as some of them lost money in the investment a few years ago. They have got a phobia to invest in the company, and would ignore the profit growth potential of the stock even though the fundamentals of the business had shown some signs of improvement.

In addition, people tend to avoid buying stocks immediately after seeing blood in the streets, or experiencing huge losses in the bear market, even though the prices are dirt cheap. The recency bias results in people overestimate the probability of event happens in the recent past (that the recent market crash has rendered a sharp rise in bankruptcy rate), and give lesser weight to the event that happens in a distant past (that the last bull run rewarded many contrarian investors generously). To be an intelligent investor, we should be aware of the bias, make our judgements based on facts, focus on the long-term objectives of our investments, pay attention to the companies' profit growth potential, and look at the long-term trend of the stock markets,

not the short-term movement of stock price. Statistics show that stocks are relatively cheap every time after the market crash. The worst is always behind us when the markets bottom out. And the best time for bargain hunting and accumulating fast-growing stocks is when they turn the corner, or when there is blood in the streets. If we hesitate for a minute, our rewards will be gone in no time.

4.1.6 Refuse to Cut Loss

"*Letting losses run is the most serious mistake made by most investors*."

William O'Neil

Another behavioural bias people always stumble upon is their refusal to cut loss when they discover that they have made some mistakes in their original analysis work, or when the situation has changed, and the reason to hold a stock is no longer valid. The reason why investors refuse to sell the losers is due to disposition effect ("*the tendency of investors to sell shares whose price has increased, while keeping assets that have dropped in value*." Source: Wikipedia). Further, they do not want to feel shame, and to get the pain for booking a loss. Therefore, they tend to hold on to their losers for a very long period of time, and sell the winners very fast. They believe that as long as they do not realise their loss, the paper loss is not considered a loss, and they will not miss the chance to win back when the tide turns. The worst is that some of them have a tendency to take a greater risk after devoting so much time, energy and money in the investments and are still suffering some losses. They will add to their losing position by buying more of the down-trending stocks at lower prices. This fallacy is called sunk cost fallacy.

Also, investors always forget that share price seldom declines continuously for no reason. Price fall related to fundamental business problems such as oversupply issue, and increasing operating costs will linger a very long time, and very often may continue to depress the stock price until the issues cease to have a significant influence on its earnings. When a business's highly profitable go-go days are gone, it will take a very long time for the stock to regain its former glory. The best thing we can do is to dispose the stock as soon as possible before its price collapses (so that our investment will not be affected by the decreasing revenues, and the earnings disappointment), and then use the proceeds to buy stocks with better earnings growth potential (to avoid falling trap into the bias of loss aversion). Holding on to the losers will only deteriorate our portfolio performance, and make us feel more depressed.

4.1.7 Invest with Wishful Thinking

"*Never act upon wishful thinking. Act without checking the facts, and chances are that you will be swept away along with the mob*."

Jim Rogers

Just like gamblers, some investors also have a tendency to invest with wishful thinking. Many of them do not invest with realistic expectations and focus on facts; rather this group of investors lives on wishful thinking. They follow their friends falling for the popular myths that everyone believes. Moreover, they pay high prices for non-performing assets, and wish that the stock prices will go higher, and expect other fools to buy the trashes from them generously. They should know that this type of situation is untenable, and the trend is subject to reversal when the market wakes up one day to realise that the stocks are unworthy of their money. Another scenario is that they buy some good stocks at attractive prices, and then set their expected return unrealistically high, and they wish that the market will reward them generously for the investments. Whilst the market may sometimes be irrational in their willingness to pay for the good assets, very often having a disappointment for investing with unrealistically high expectations is evitable.

Further, the investors who take a greater risk after suffering some losses always invest with wishful thinking. They will buy more shares with a greater sum of money after losing money in a stock in the hope that they can win back the money they have lost in the previous investment. As they increase the sum of their investment, they are actually taking revenge after getting clobbered by their failed investment, let their anger influence their judgement, and wish that the stocks, which have reached new lows, will rebound. That is why they buy even more shares, and up the ante as the price keeps falling. And they wish that the rebound will occur soon. They are definitely unprepared for the any unforeseen circumstances. If the stock price falls lower, they will definitely be in financial trouble if they buy using margin finance. Bear in mind that what goes up must come down, but what comes down may not necessarily go up. Making judgements based on a false notion, and without having evidence to support our hypotheses is a dangerous move. Stocks seldom fall to their historic lows for no reason. The companies are either suffering from financial distressed, or facing oversupply problem. Never expect a troubled company to pull a rabbit out of its hat, unless there is sufficient evidence showing that the problem has been addressed with business expansion, and earnings growth in the pipeline. In investing, there is no magic dust to bail us out for our mistakes. Do not take a greater risk after a loss. If you insist on doubling your stake in your failed bet when the stock price falls, you must make sure that you know the root cause of your failure, and that the odds are now stacked in your favour prior to committing more capital to the investment.

4.1.8 Value Stocks in Possession Unrealistically High

"*……people are more likely to keep what they start with than to trade*"
Richard Thaler

People have a tendency to value things in their possession higher than the prices quoted in the markets, and higher than the things they have not yet own just because they own the things. This bias is called endowment effect. Again, this shows that people do not always look at the facts, and live in their dream. They are inclined to value their own properties higher than their market prices. For example, if a house is for sale at Rm 100,000, and the market value of the property is also Rm 100,000, the potential buyer will probably find it pricey before buying the property. But, after purchasing the house, he or she will think otherwise. He or she will claim that the property is undervalued and can easily fetch over Rm 150,000 or more.

To prove this bias, Daniel Kahneman, Jack Knetsch, and Richard Thaler conducted an experiment by distributing mugs to half of their students, and ask the students to sell the mugs to the other half of the group who did not have the mugs. They found out that those students with mugs had a tendency to overvalue their possession, and placed a higher selling price for their mugs than the price offered by another group of students due to the mere ownership effect called "endowment effect". In another experiment, Kahneman and his colleagues distributed mugs to half of their students and chocolate to the other half of the group, each with the same value. The students are then asked to trade with their possession. In the end, they found out that only a small group of students were willing to part with their original possession.

This divestiture aversion behaviour is also commonly seen in investing. People always fall in love with the stocks in their portfolio, assets they inherit, or something they are familiar and comfortable with, and are inclined to believe that the stocks they possess are worth more than their market values, regardless of their real values, and have a tendency to remain at the status quo. Therefore, they refuse to sell the stocks in their possession then use the proceeds to buy other stocks with better profit growth potential, even though the reason to keep the original stocks in their portfolio is no longer valid. For example, if an investor bought stock A last year at Rm 1.00/share, he or she expected the stock to rise to Rm 2.00/share in a year, but so unfortunate that the business faces some headwind, the EPS of the stock fails to increase, and the stock price hovers at Rm 1.50/share level for a year. At the same time, stock B, an undervalued stock selling at Rm 1.50/share, seems to be a better investment for the investor. Do you think the investor is willing to sell stock A for stock B? The most probable answer to the question is "NO". Behavioural bias theory tells us that it is very unlikely that the investor will sell stock A before their expected value is reached, so that he or she could use the proceeds to buy stock B. As he or she sticks

with his or her original possession, he or she will eventually miss out on a good investment opportunity.

4.1.9 Overconfidence

"*Overconfidence is a powerful force*."

Richard Thaler

People also have a tendency to overestimate their own ability, efficiency, intelligence, and knowledge level. Most of them believe that their investing skills, knowledge, and strategies are superior to other market participants. Whilst having confidence is important to our personal success, overconfidence on the other hand may hurt our investment performance, and may be detrimental to our continuous learning. Overconfident investors always believe that they are better than other people in stock picking. Therefore, they are not prepared for what may go wrong with their investments, and will not be prepared for any unforeseen circumstances that may stack against them. For example, if an investor believes that a company has a bright future, or that he or she has found an investment which will provide him or her an exceptional return, he or she then bets big on the stock without identifying the possible threats that may jeopardise the business, or listening to the critical comments of people in the opposite camp, he or she is prone to a shock when the stock price and earnings take a hit, and he or she may be unable to get out safely.

In addition, people have a tendency to feel overconfident and wager aggressively after winning a few small bets. It is very normal that after a few consecutive of winning games, we will take it for granted that the odds will still be in our favour in the next few investments, and we will be getting very greedy in the pursuit of more rewards. But staying in the game with an exaggerated swagger is a deadly mistake. Again, shock always occurs when we fail to foresee what may go wrong with our investments, and we are susceptible to a huge financial loss if we insist on moving ahead in foggy situations with overconfidence before the vision gets clearer.

Whilst both genders generally exhibit the same trait, studies show that overconfident is more prominent in men than in women. Male hormone always leads men to be more confident, and to make high-risk gambles. In comparison, men trade more frequently (and often excessively) than women, and men suffer lower returns with higher trading costs. They always believe that the investing decisions they make are right, even though sometimes they may not know what exactly are they doing, and may not be aware of the presence of some blind spots and the consequences of their decisions. Women, on the other hand, are more likely to acknowledge their ignorance if they do not know anything about a company, and are more risk-averse in making any investing decisions.

4.1.10 Reject Opposite View

"*We were also well aware of the dangers of what social psychologists call confirmatory bias, in other words the tendency to collect all the information that agrees with your position and to ignore the information that doesn't. Behavioural theory teaches that the best antidote to this bias is to listen to the opposite side of the case and then dispassionately to identify the logical flaws in the argument*."

Barton Biggs

In investing, people do not like negative comments about their stocks, and always search for reasons and information to confirm their investment decisions. This type of bias is known as confirmatory bias (or confirmation bias). According to studies, investors are twice more likely to look for information and interpret ambiguous evidence in a biased way to support their decisions rather than to look for flaws in their original hypotheses. At the same time, they ignore the impact of contradictory facts on stock price. For example, in 2014, when OPEC (Organization of the Petroleum Exporting Countries) ramped up their production of oil to 30 million barrel per day, and was in a price war with the shale oil producers of the United States, the price of oil started plummeting, people who were optimistic about growing global oil demand were not only refuse to sell their oil and gas related holdings, and ignore the fact of increasing crude oil inventory and the impact of supply glut, they kept finding reasons such as depleting oil reserves and surging demand of oil from China, India, and emerging countries due to GDP growth to shore up their arguments. In the end, those investors who refused to listen to the opposite view, and clung on to their beloved oil and gas stocks eventually suffered huge losses when the prices of their oil and gas stocks tanked, as the price of crude oil plunged to the level below USD30 per barrel in 2016.

When like-minded investors get together in a group, they have a tendency to form a stereotype view. They will reject those opposite opinions, alternative views, and disconfirming information, and ignore warnings. They then strive for unanimity. To achieve their goal, they also impose pressure on and angry with the dissidents or people in the opposite camp. They distort facts and information to justify their hypotheses and decisions. At the same time, this group of people will use mind guard to prevent their group members from accepting any opposite opinions. Independent thinking is lost when everyone is indoctrinated into believing the distorted stories and trusting the philosophy which may be composed of false notions, and unable to think for themselves, as they are afraid to be criticised by the group members. The groupthink or group polarisation, whilst seems to help the members to stay confident, is actually a curse in disguise, which very often does more harm than good to investors, and will lead to over-optimism and overconfidence.

"*For if we are uncritical we shall always find what we want: we shall look for, and find, confirmation, and we shall look away from, and not see, whatever might be dangerous to our pet theories*."

Karl Popper

4.1.11 Overly Focus on Short-term Performance

"*When an investor focuses on short-term investments, he or she is observing the variability of the portfolio, not the returns - in short, being fooled by randomness*."

Nassim Nicholas Taleb

Our market is mainly dominated by short-term oriented investors who concentrate too much on short-term price fluctuations and noise, always aim for quick profits, and exit a stock position after holding the counter for a few days, regardless of its earnings growth prospects. They will rush in to buy a stock when there is a rumour about the company, and feel the urge to sell it when the holding starts showing some gain. They call themselves serious investors, but their average holding period is less than a week. They prefer speculative stocks with higher volatility to stocks with good long-term earnings prospects. They are unable to see the long-term earnings potential of a company. In investing, we call this a problem of short-sightedness or Myopia.

This group of overambitious market participants also devotes too much effort to predict the short-term price movements of a stock, and ignore the underlying business and its profit growth potential. They think they have the ability to predict the market and to beat the market short-term, but their portfolios always end up underperforming the market averages, if not with a abysmal loss. Again, this shows that people always overestimate their own abilities, and underestimate all the competitors – including those sophisticated investors who are not only knowledgeable and experienced in investing, but can access to the latest news within seconds, are able to predict the short-term earnings quite well and outmanoeuvre the market.

In order to increase the winning probability of their short-term bets, sometimes they are willing to pay lofty service fees to investment consultants for hot-stock tips and investment advice. However, those tips are mostly inaccurate ones, and the returns of their products always underperform the market. Even if those products are magnificent ones, after deducting the consultation fees, brokerage commissions, and other transaction costs, only a paltry gain is left over. In the end, they still get beaten by the market. Keep in mind that these investment consultants do not have a crystal ball too. Just like you and me, they do not have the "supernatural ability" to accurately predict the short-term stock price movement either.

That said, it is not hard to beat the market in the long-haul game. As those active investors, such as professional money managers, day

traders and other short-term oriented market participants (who constitute a greater proportion of the market) are overly focused on the short-term performance of a stock, the long-term earnings prospect of the company has been largely overlooked. This is the area where smart contrarian investors with fortitude and patience can outperform the market, and be handsomely rewarded if they only concentrate on investing in undervalued companies with bright earnings growth prospects.

4.1.12 Refuse to Admit Mistakes

"*There's obviously a balance to maintain between confidence and humility. You have to be humble enough to recognise when you're wrong. I'm willing to look silly.*"

Bill Ackman

Would you admit your mistake when you do something wrong? In most cases, people are just unwilling to admit their blunders. There could be many reasons why people refuse to admit them, but the most obvious one is due to egoism. In general, big ego hinders self-assessment, affects visibility, and ruin investing performance. People with the self-importance problem always seek glory, crave for credit and compliments, boast achievements, and are unwilling to recognise their weaknesses. In addition, they have too much pride to accept the advice of other people. Even if they make bad decisions, they would give all sorts of justifications for their errors. In the end, this group of people always sticks to the wrong hypotheses, flawed philosophies, and the poor perceptions of their investments. They are predisposed to repeat the same old mistakes again and again.

In investing, it is easier to make mistakes than to make perfect "moves". That is why we make so many mistakes every year. From a psychology perspective, these failures will cause emotional pains and kill our self-esteem. But from a learning perspective, these mistakes (be it misjudgements, misinterpret data, misestimate earnings, or mistimed shots) make us grow and stronger. In other words, if we are willing to accept the embarrassment, take responsibility for our incompetence, and correct the misconceptions, our investing skills will improve significantly. Unfortunately, many stubborn investors are simply unwilling to admit their fallibility, so as to avoid feeling shame. Keep in mind that people who are reluctant to control their emotions and refuse to admit their mistakes seldom learn, and hardly will they see much improvement in their investment performance.

4.1.13 Poor Self-Awareness

"*The first thing you have to know is yourself. A man who knows himself can step outside himself and watch his own reactions like an observer.*"

George Goodman (pseudonym Adam Smith)

Very often the failure of people in investing has been stem from not having a good understanding of themselves. How can anyone formulate a viable investing plan, rule and strategy for himself or herself if he or she does not even know his or her own personality, strengths and weaknesses? We always hear people call themselves long-term investors, but they behave like short-term traders. They trade so frequent that their portfolio turnover ratio is very often greater than one, and the transaction costs will eat into their lifetime savings. Some of the people wanted to follow those über-investors like Koon, Glenn Greenberg, Charlie Munger and etc. to put all their eggs in only a few baskets and watch the baskets closely, but they do not have the stomach for concentrated investing. They do not have the discipline to perform due diligence, to devote effort for soul searching, unable to demonstrate the abhorrence of action, and cannot hold stocks for long-term. After building a substantial position in a stock, they feel uneasy, are unable to sleep well, and intend to exit their position as soon as possible. As they dispose their holdings hastily when the stocks are declining in price (or selling below their buying prices), their portfolios will suffer a loss.

Also, having a poor understanding of oneself is the reason why people cannot see their own bias – blind spot. They always think they are less subjective to some cognitive biases than the other market participants, but in actual fact they are also the victims of the biases. For instance, people always overestimate own ability and underestimate the other people's talents, and they claim that they can control their emotions better than other market participants. But they eventually turn into panic sellers when the market crashes and join the crowd buying aggressively when stocks are selling like hot cakes.

Poor self-awareness is also one of the factors leading to self-attribution bias. People often give credit to their own skills, talents, and knowledge for their success, but they blame others' mistakes, market conditions, environment, government policy, price volatility, bad luck, and other factors for the poor outcomes. They must understand that other than disavowing responsibility and avoiding feeling shame, the externalisation – blaming others for causing their loss – will not benefit them for their own growth. To be a better investor, one should identify his or her own strengths, and recognise his or her weaknesses, and learn continuously to improve his or her investing skills and philosophies.

4.2 Part 2: Solutions to Addressing the Mental Pitfalls

"*It is crucially important not to let psychological factors interfere with economic rationality in investment decision making*"

Bill Ackman

Having discussed about how stumbling into behavioural pitfalls can lead us astray, we can deduce that investing is more to do with the art – of dealing with human emotions and behaviours – and less to do with the science. Our emotions such as greed, fear, joy, pride, exuberance, frustration, impatience, and anxiety can be great obstacles to our success in investing. Our swing of mood, irrational thoughts, biases, fallacies, illogical decisions, illusions, paradoxes, and self-defence mechanisms can affect the outcomes of our investments. The combination of the above-mentioned pitfalls is a perfect recipe for the devastating outcome.

Although having the fundamental value investing and technical analysis knowledge is important, mastering the art of managing our emotions, behaviours, and consciousness is the key to successful investing. Koon always says, the stock market is really a jungle out there. We would be mauled by "tigers" if we are not equipped with the necessary investing tools to survive. Our survival in investing requires far more than analytical skills. We need to have the right temperament, mentality, habit, thinking, and plan to succeed in the market. The market always swings from one end to the other. In the long run, if we stick to our guns, understand human behavioural biases, avoid falling into the psychological pitfalls, follow some of the solutions discussed below, and managed to elude those unnecessary blunders discussed earlier, we should be able to do well with our investments.

"*It is far safer to project a continuation of the psychological reactions of investors than it is to project the visibility of the companies themselves*"

David Dreman

"*The psychologist far more than the economist may be of help in deciding when to buy*"

Philip Fisher

4.2.1 Learn to Understand Yourself

"*To know thyself is the beginning of wisdom.*"

Socrates

People always ask Koon how he achieves such a spectacular performance in his investments and if he has any supernatural abilities to accurately predict the movements of stock price. Well, like many other investors, he does not possess any crystal ball to foretell the future, and is unable to cast magic spell like Harry Potter. However, he does share a few important traits with other master investors that enable them to outperform the markets. One of the traits is self-

awareness. From my observation, all successful investors have high self-awareness.

Having high self-awareness, in this case, is referred to knowing our personalities, strengths, competency zones, limits, vulnerabilities, objectives, self-interests, and motivations. This is an essential step to achieving unbeaten performance. By developing a deep appreciation of ourselves, we are able to formulate suitable investing strategies and rules that fit our characteristics and investing styles, enable us to navigate our way through the up and down cycles of our investing journeys, make us undeterred by temporary failures, and enhance the ability to overcome our behavioural biases. That's why Bernard Baruch said "*only as you know yourself can your brain serve you as a sharp and efficient tool. Know your own failings, passions, and prejudices so you can separate them from what you see*."

There are many ways we can do to get to know ourselves better. One of the methods to understand our persona is by taking Myers–Briggs Type Indicator (MBTI) test. The test is specifically designed to identify our preferences, attitudes, and psychological functions (extraversion, sensing, thinking, judgment, introversion, intuition, feeling, perception and etc.), and help defining our temperament (sanguine: enthusiastic, active, and social; choleric: independent, decisive, goal oriented; melancholic: analytical, detail oriented, deep thinker and feeler; and phlegmatic: relaxed, peaceful, quiet) *Source: Wikipedia.* In general, extroverted investors, with thrill-seeking gene and opportunity-oriented strategies, like Peter Lynch, Robert Arnott and Mark Mobius, do exceptionally well in bull markets. On the other hand, introverts like Warren Buffett, Jeremy Grantham, Charles Schwab, and Bill Miller, who are mostly contrarian, passive, thorough, careful, risk-averse, calm and patient investors and enjoy in solitude, do better in bear markets.

Another approach to understanding ourselves better is by performing self-assessment through the continuous experimentation and reflection of our philosophies and strategies. The reflection on our philosophies and strategies helps us identify our strengths and weaknesses. For example, when we reflect on our decisions and actions in our investments, it indirectly reveals to us our tolerance limit, mental power, circle of competence, competency level, comfort zone, and etc. We will be wiser investors as we reduce our blind spots, and make better decisions. Moreover, it allows us to determine our boundaries so that we will not go outside our zones of competence, and are able to minimise risk to an acceptable level.

4.2.2 Stick to Your Investing Rules

"*Sacrifice money rather than principle*."

Mayer Amschel Rothschild

"*If you took our top fifteen decisions out, we'd have a pretty average record. It wasn't hyperactivity, but a hell of a lot of patience. You stuck to your principles and when opportunities came along, you pounced on them with vigor.*"

Charlie Munger

Having a good understanding of ourselves is a vital step to improving our investing performance, but it does not provide us any guidelines on how the stock selection should be made to meet our objectives, and to achieve our missions. Unfortunately, there is no "one-size-fits-all" rule for everyone to score a home run in the market. Therefore, just like Koon, we need to have a set of our own investing principles or rules, which is developed based on our risk tolerance limits, personal traits, strategies as well as our areas of competence, as a guideline to pick the right stocks for our portfolios, and we must adhere strictly to the rules.

Study shows that unemotional investors who stick to their own golden rules and game plans always walk-away with magnificent and covetable returns. Moreover, sticking to our rules allows us to sense danger early so that we do not put our capital at risk. Our investing rules indirectly provide us a strong defence system, in which the rules usually dictate the conditions and criteria each stock must meet before it qualifies a place in our portfolios, such as the potential of business expansion, future earnings' trajectory, enterprise value and earnings multiples, profit margins, cash flow trend, financial heath, and management's integrity, so that we can be sure of the odds are not stacked against us.

Further, following our own rules can help addressing terminal paralysis – a syndrome of inability to pull trigger when an opportunity arises – and to prevent us from falling into the trap of representation bias – a tendency to judge the probability of an event or a hypothesis based on the resemblance of the event or hypothesis to the commonsense data and past memory. For example, in the case of representation bias, turnaround companies are often stereotyped as doomed-to-failure businesses. Their potential to revive and thrive is often overlooked by the market and is regarded as an impossible thing. However, that is an area where enormous return could be expected if the turnaround company that we invested in does exceptionally well. Therefore, sticking to our rules is very important to investing success. Had Koon not stuck to his golden rule, and had he allowed his vision be clouded by the cognitive bias, he would have missed out on many good opportunities.

Another example of representative bias is that people always associate blue chip companies with winning stocks. They blindly believe that this type of companies will do well forever and buying dear does not matter. Long-term investors who bought British American Tobacco Berhad (BAT, which is regarded as a blue-chip stock) around Rm 75 per share in 2014 definitely have their fingers badly burned. As of now,

early 2020, the share price of BAT is only Rm 12 per share. In retrospect, investors should have avoided the stock at all costs, had they studied the earnings growth potential of BAT in 2014. The rampant and escalating illicit cigarette trade had started eating into the market share of BAT in 2014, and would have a profound impact on its earnings. It was not difficult to fathom the decreasing price trend of BAT if we had analysed its sales and earnings from a business perspective. By sticking to his golden rule – only buy undervalued good stocks with high profit growth potential – Koon managed to spot many opportunities and dangers early, and avoid the predilection for stocks with beautiful stories such as BAT and other cognitive biases.

"*It remained true that sound investment principles produced generally sound results.*"

Benjamin Graham

4.2.3 Deliberation and Hard-work

"*The only way to gain an edge is through long and hard work.*"

Li Lu

Despite our frequent stumbles on the above-mentioned biases such as overreaction, over-optimism, and framing effect, study shows that our investment performance could be improved greatly if we have done adequate preparation before any "war". For instance, to avoid getting caught up in a buying frenzy, we can spend some time to search for our targets early when we are in a rational state, so that we will not rush to buy a stock in the irrational modes of thought just because all market participants and pundits shout 'buy'. Things we can do include, but are not limited to, reading annual reports and financial statements, performing a comparison study, and visiting companies.

After studying the business of a company, if the company is found to have a bright earnings prospect, we should put the target in a list called "wish list" or "watch list". By doing so, we have screened out all the stocks that do not meet our selection criteria. We then monitor the price of the stocks in our watch list daily. Remember, we only have to monitor them daily, not hourly, so that we have more time to search for other good deals, and for other matters (i.e. our day-job and family matters). When it comes to buying, we only buy the stocks in our watch list, not any speculative counters or hot stocks.

After buying the stocks, we then review their performance regularly. The reason why we perform the review is to avoid getting trapped in a crowded theatre when everyone yells fire in panic state later. When the tide and facts change, we change our perceptions, price targets, and decisions immediately to adapt to the new situations, so that we do not steadfast to the old ideas, which have become obsolete, and to avoid falling into the trap of anchoring bias. That's why Lord Keynes said "*When the facts change, I change my mind, what do you do sir?*" If we

always stay abreast of a company's development and progress, we would not be missing out on any buying or selling opportunities, and should be able to seize the opportunities to "move every piece" ahead of the market. In essence, we make hay whilst the sun shines.

Most importantly, never follow any tips from our friends, analysts' reports or news blindly. We should maintain our intellectual independence, and rely on our research work. Our friends are more likely to be wrong than right. Study shows that about 90% people lose money in the stock market. Our friends may not be willing to come to our rescue when we are "stranded" in the depressed counter later for listening to their tips. Analysts, on the other hand, always report something good to support their own interests. Do not fall victim to their traps. Additionally, their forecasts are seldom right. Be more sceptical and take the reports with a pinch of salt. Some of them have very little or no skin in the game. They are paid to write for the companies or syndicates. Moreover, some of the tips given by opinion makers and market pundits are inaccurate ones. They may be hyping the stocks that they intend to sell soon. Whilst the news reported by media may not be outdated ones, the positive factors may have already been priced into the stocks when we buy them. Smart traders will exit their positions once the news is released. Keep in mind that market participants always buy the rumours and sell the news. Therefore, we should be wary when we are dealing with the type of stocks, especially those in a rigged market, that have gone up substantially before any good news are released.

To avoid making any dubious moves, we should reduce the level of risks to an acceptable level before plunking down our hard-earned money for any companies we have never run before. The important thing is don't bury our head in the sand. Uncertainty is always there. We should embrace it, not ignore it. Before buying them, try to understand as much as we possibly can about the businesses, including the future of their industries, their capacity for business expansion, profit margins and profit growth potential. The uncertainty stems from missing information can be reduced by devoting more time to conduct research (to search for the missing piece of the puzzle). Noisy information can be eliminated by filtering the unreliable and non-related information. Conflicting information can be addressed by finding the discrepancies between the two types of information and making an informed judgement. We should also learn to handle the internal conflict in our mind, and keep focusing on facts. In the worst case, if we cannot handle any of the uncertainties, especially when the uncertainty level is exceptionally high, stake is high and reward is low, we should just give it a miss.

Study shows that our emotional intelligence can also be improved if we put in more effort to manage it, and to understand the behaviours of the market. In order to avoid selling a stock in panic with the crowd when everyone is terrified after a big drop, we can always prepare for any

unforeseen circumstances before the reversal occurs. For instance, we can perform pre-mortem before executing a trade to find out what could cause a decline in the price of the stock, anticipate the respond of other market participants, and learn from the simulated experience how to react to a bad situation. This will prevent us from risking our own money, prepare us better for any unforeseen developments, and allow us to control our emotions well. The second benefit is that when we devote more time to empathise with other market participants, we will know their objectives and feelings. Our stock market is made up of trading and investing participants. We will be able to anticipate their next move, deploy our plan, and respond to the conditions better if we understand their behaviours.

4.2.4 Maintain the Discipline

"*You must have the patience and conviction to stick with what is, by definition, an unpopular bet*."

Whitney Tilson

In order to avoid being swayed by other's errors or ill-intentions, and to achieve satisfactory performance in investing, it is important that we maintain our discipline in investing. Once we have established our investing rules, and devised our investing plans, we should follow our own systems closely, not the crowd. For example, we should use the investing strategy that suits us the most, not the complex financial models, and strategy used by some fund managers. Instead of buying hot-stocks of the month, we should only buy the stocks the meet our selection criteria.

People will feel nervous when their holdings plummet in price, or get greedy when their holdings are in winning positions. They always overreact to noise. When their friends shout "buy the stock before it shoots up", they have a tendency to go big into the stock. Instead of following our friends, we should keep a level head when the market is in the state of panic or jubilation. Study showed that level headed investors always make wiser investment decisions than people who are less emotionally intelligent. Also, price volatility is a part of the investing game. If we can ignore price fluctuation and the noise, keep our sanity, and be prudent when making important decisions, we will do well in our investments.

People also always fail to pull trigger on their investing ideas, as they spend too much time thinking about the company's future when opportunity arises. Likewise, they will be hesitating to sell their holdings or cut loss when the fundamentals of the business have changed, as they gamble on with a hope that their losses will be recovered when the share prices rebound. To prevent procrastination, we should buy immediately when a stock meets our criteria and sell immediately when its fundamentals have changed. We should not hold on the losers when their business fundamentals have changed. For

example, when companies report decreasing revenues or sustained losses due to supply glut issue, we should sell our stocks immediately. Limit our loss will ensure that we stay out of the companies. Bear in mind that the first loss is the easiest loss. We need a 100% gain to recover a 50% loss if we do not follow our cut-loss rule when the market slices it.

In addition, we should maintain our discipline – to be patient if we have nothing to buy or to sell. Very often successful investors get paid for doing nothing. This is one of the best strategies in investing. Charlie Munger calls it "sit-on-your-ass investing". On the contrary, if we trade too frequently, our wealth will be dwindled by the commissions charged by our brokerage house for our in-and-out activities. If you feel bored, instead of getting in and out, you can use the time to search for more targets and prepare some dry powder for the subsequent round of bargain hunting.

4.2.5 Concentrate on the Facts

"*You need to probe a whole raft of numbers and facts, searching for confirmation or contradiction.*"

John Neff

To avoid falling trap into the common behavioural biases, superinvestors usually pay more heed to the facts of a stock, not the beauty of its story. They look for stocks selling substantially lower than their business value. They look at the earnings growth potentials, current earnings, earnings trend, dividend yield and cash flow of a company, so that they can make an informed judgement, and exploit the emotions of Mr. Market.

If we follow the principle of those superinvestors of focusing on the numbers, use logical thinking coupled with business sense to analyse opportunities, and buy stocks with tremendous profit growth potential and with low downside risk, we are less likely to be penalised when the stocks are not performing for a couple of quarters, as the pessimism has already been priced in. In addition, our hard-work will be paid off when the companies report increasing profits as the positive earnings surprise will help lifting the share price. Further, if we make judgements based on the facts, it is not difficult for us to spot bubble in a stock.

Even if we do not have strong financial acumen to accurately assess the value of a business, the least what we should do is to have an unbiased perception of the market, stick to the facts, and avoid following the irrational behaviours of the others. And most importantly, we should ignore the estimates based on straight line extrapolation, and take those research reports published in online forums with a grain of salt. Some of the reports are written with ill-intention to hoodwink us into buying the stocks at inflated prices from syndicates when in fact the companies

have been found with rats infested in the engines. Whether or not we find the reports sensible, we should perform our own due diligence before buying into the stocks. In many cases, the morsels left may not be worth our money.

"*What I try to do is focus on the facts of today.*"

Bruce Berkowitz

4.2.6 Tap into Your Powerful Intuition

"*Intuition is more than just a hunch. It resembles a hidden supercomputer in the mind that you're not even aware is there. It can help you do the right thing at the right time if you give it a chance. In fact, over time your own trading experience will help develop your intuition so that major pitfalls can be avoided.*"

Michael Steinhardt

Intuition is a powerful tool that provides us a cue accessing to the vast amount of information stored in our memory and to protect us from dangers. Unfortunately, intuition is very often ignored by maladjustive investors, and is always deemed as a noise that impedes their valuation of companies by this group of investors. A good decision-making process should not be depended solely on the deliberative mode of thought or reflective mind; intuition also should be made use of in order to achieve a better performance in investing.

In investing, you certainly do not want to have your lifetime savings stuck in a stock that has been hard hit by the industry downturn, or with a serious oversupply problem, even though it has a very low debt level, high net working capital, and a healthy balance sheet. When we analyse the company's business and financial health, our deliberative thought could only tell us that the balance sheet is clean, and that the company is less likely to get into financial distressed problems, but it does not tell us anything more than that. It is our intuition, which formed through years of learning and experience, can help us judge if it is a value trap, and can tell us that we need to hold the stock for many years, if not decades, for us to see the light at the end of the tunnel. For instance, currently there are many property stocks selling below their NTA (net tangible assets value) due to the oversupply of properties in every town and city in Malaysia. Yes, it is safe to buy some of them as their balance sheets are clean. But Koon is not buying any of them. According to him, his intuition tells him that their prices will remain depressed for many years until the property market turns the corner. If he makes his judgement solely based on fundamental or technical analysis, most likely he will get trapped in the stocks for many years.

In an interview at the University of California, Berkeley, Daniel Kahneman told his host and audiences that intuition is also critical to the careers of many people, including firemen and nurses. He further shared the findings of his research partner, Gary Klein, that "*a fireman*

on the roof suddenly yelling to his company, "let's get out of here," just before the house explodes, and then it turns out he wasn't aware of when he was doing it, but his feet were warm and that was the cue that triggered the sense that something very dangerous was going on just underneath them." According to Professor Kahneman, even experienced statisticians use intuition and heuristics to solve problems generally, instead of the complex mathematical models they have mastered.

Similarly, in investing, most of the successful investors do not buy stocks based on the discounted cash flow of the stocks. What they normally use is a set of heuristics called the rule of thumb or criteria (some simple calculation) coupled with intuition to judge if a stock will make a profitable investment at a particular time. Based on Charlie Munger's observation, "*Warren* (Buffett) *often talks about these discounted cash flows, but I've never seen him do one. If it isn't perfectly obvious that it's going to work out well if you do the calculation, then he tends to go on to the next idea.*" Intuition comes from our recognition of patterns such as trends, similarities and differences. It is built through years of hard-work, focus and experience. On the other hand, Wikipedia defines heuristics as simple, efficient rules which people often use to form judgments and make decisions. These information and rules form a mental map, which seasoned investors always use to match with the current development, and make the best decisions. That is why superinvestors can make judgements fairly quickly, and invest with conviction without having their performance being compromised.

Superinvestors like Michael Steinhardt, Bernard Baruch, and George Soros, always rely on their instincts (some call them "animal instincts") for important investing decisions. One of the ways how they tap into their intuitions is by monitoring their body response. Acute back pain, rapid heartbeat with anxiety, throbbing headache, or nausea with disgust is perceived as a signal of impending peril by some of them. The signals are stored as somatic markers (feelings associated with emotions) in probably their ventromedial prefrontal cortex. The signal is usually triggered in their brains when they went through something unpleasant they had experienced in the past or they encountered something in stark contrast to their objectives. That is how their nervous system responds to their emotions – by triggering an acute pain to the physiological system, as both of which are inextricably connected. The claim is attested by the findings of a group of psychologists of the University of Virginia that "*when we feel heartache, we are experiencing a blend of emotional stress and the stress-induced sensations in our chest—muscle tightness, increased heart rate, abnormal stomach activity and shortness of breath*."

That said, relying solely on our intuitions can lead to some cognitive biases in some situations. For example, an investor who relies heavily on his or her intuition, refuses to pay heed to counterfactual analyses

and contradictory views (which will mar his or her hypotheses), and insists that his or her intuition indicates that the same patterns will be repeated again are highly susceptible to overconfidence bias, which may result in a mediocre performance. Therefore, we should avoid making judgements purely based on gut instinct, or purely use heuristics as a solution to our problems (as heuristics can sometimes turn into harmful biases). We should guard it with logical thinking as well as with adequate research and analysis. Experience can only help us to a certain extent; it cannot solve all of our problems. The most important thing is to avoid extrapolating unrelated experience to our decision-making process. It will result in pareidolia.

Also, despite the fact that the combination of intuitions and heuristics works well under general circumstances and help investors make sound decisions, new investors are not encouraged to follow their intuitions. Their experience in this field is too little to help them make good decisions. It takes effort and years of experimentation and experience to form the database in their minds and reliable intuitions. Therefore, new investors are usually advised to perform due diligence – by conducting sufficient research and analysis – prior to placing their wagers on stocks, and should continue doing so until a massive wealth of experience and expertise in this area are accumulated to enable the reliable intuitions be formed.

4.2.7 Close the Empathy Gap

"*Successful investing is anticipating the anticipations of others*"

John Maynard Keynes

Merely knowing how to read charts and financial statements, or to value companies is not enough. We need to have a good grasp of the market participants' "heartbeat". Even if you have an MBA or a PhD in finance, you can only use your finance knowledge to a certain extent, to estimate the intrinsic value of a company as guidance, and to look for the ballpark figures of a company's earnings, not the precise numbers, let alone the exact price of a stock. In investing, we need to know that apart from the value of a business, greed, fear and other psychological factors have also been largely embedded in its stock price. This is the area where the largest chunk of gain can be expected, but it is basically ignored by market participants. Keep in mind that stock price is dictated by human's "animal spirits". If the spirits are low, fear and pessimism levels are high, and confidence levels plummet, it's highly likely that the stock price will fall. This is more evident in turbulent markets.

To have a good grasp of the market participants' emotions, we need to have a combination of good cognitive empathy and emotional empathy. Being good at cognitive empathy means we are able to put ourselves in someone else's shoe, experience what they are going through, and see problems from their perspective without necessarily feeling their joys

or pains. Being good at emotional empathy, on the other hands, means we can feel the emotions of other people so that we understand the feelings and reactions of them but without having ourselves overwhelmed by their emotions. By being good at both, we are able to simulate the same problems people encounter and the same emotions they have, know what they are thinking, understand their states of mind, and anticipate the responses of the crowd in the market when reading their comments and analysing the trade volume and chart pattern of a stock.

Having the ability to close the empathy gap is also helpful in interpreting data stated in financial reports, knowing the direction of a company based their corporate strategy, getting more hints on the hidden agenda of management's actions, and having an appreciation how the market perceives the strategy of the company. For example, when a company proposes a private placement, it probably signifies that the company is raising funds to expand its business, repay loans or for other purposes. Upon reading the announcement, the market will naturally sell it down at a loss without investigating the objective further, as it is deemed diluting the existing shareholders' interests. To be good investors, we must be able to control our emotions, gather all relevant information, read between the lines in the proposal to get a hint, and perform a thorough analysis of the proposal before arriving at the final conclusion. If you find out that the private placement is beneficial to both the company and the existing shareholders, and you are in a resourceful state of mind (calmed, centred, confident), you should be able to exploit social awareness to your advantage for the emotional blunders committed by other people. Moreover, the ability to close the empathy gap enables us to find out if a management team is running the company only to set themselves up for life without creating value for shareholders. It also allows us to get rid of a troubled stock after going through its reports and analysing the management's actions, so that we are not there when the shit hits the fan.

4.2.8 Maintain Humility

"*You keep an open mind, keep trying to learn, stay humble and keep trying to learn from your mistakes and other people's mistakes*."

Ken Shubin Stein

"*I would recommend being humble. Be open-minded, and do not be conceited.*"

Sir John Templeton

People always fall prey to self-serving bias. They ascribe their success to their own talents and hard-work, and point the finger at external factors for their failures. For example, some of the managers always push blames to their subordinates for their teams' poor performance in order to avoid accountability. This type of cognitive bias is not just commonly seen in the workplace, but it is also typically observed in the

field of investing. It is a sad but true fact that all of us are imperfect. Nonetheless, people simply refuse to own up to committing their blunders, when they have erred in their decisions, due in part to their big ego and embarrassed perception.

To be a better investor, all of us must be willing to recognise our limitations and weaknesses and continue to learn. As we are not infallible, we should look for flaws in our hypotheses, and spend time to think what can go wrong with our hypotheses. To prevent being overconfident, we must be more open minded, always listen to second opinions or opposite views, and seek for constructive feedbacks and advice before making any judgements. If we have a tendency to make investment decision from a more emotional perspective, we should identify the biases and fallacies we always stumble upon, and correct them immediately.

Whilst all these efforts seem to humble us, they actually prevent us from repeating the same slipups, and pave the way for us to be successful in investing. Further, humility, which encourages us to avoid distorting facts, and evidences to conform to our views, or justify our errors, and make inference and judgements based on facts, indirectly make us a rational investor. Also, it prevents our decisions, and investments to be ravaged by our ego, harmful emotions, and other psychological biases. For example, I noticed that people often refuse to admit their slipups and feel embarrassed to buy back the stocks they have sold by mistake earlier, even though the growth of the companies is still intact. In addition, status quo bias also prevents them from buying back what they have sold earlier. If they can see their cognitive bias, are willing to admit their mistakes, and buy the stocks back immediately, they should be able to capitalise on the opportunity, and make a heck a lot of money out of it.

"*We think humility is essential, especially concerning the ability to know the future. Before we act on a forecast, we ask if there's good reason to think we're more right than the consensus view already embodied in prices. As to macro projections, we never assume we're superior.*"

Howard Marks

4.2.9 Keep an Investment Journal

"*I've come to believe a personal investment diary is a step in the right direction in coping with these pressures, in getting to know yourself and improving your investment behavior.*"

Barton Biggs

Some of you must be wondering why investors are advised to keep a journal (or diary) of their investing activities, even though investing has got nothing in connection with quality management, and yet it is a non-productive task. Sure, keeping a record of our investing activities

does not produce any direct positive return to our investments. But human is sometimes forgetful and vulnerable to mood swings. Our fluctuation of mood involuntarily changes the way we perceive the market, and has an influence on our trades. For example, when our investments produce some paper gains, we tend to become happy, and allow the emotion to overcome our rationality. Hence, we tend to take a higher risk, and buy a lot more shares than our original plan when their prices go up. Do not forget that our mood is contagious. The crowd will also be elated, and buy even more shares when the price shoots through the roof. When the price takes a nosedive later we regret our decisions. If we do not keep a journal of our investing activities, where do we get the recollection of how the blunders were made when we want to review our past decisions in future?

In our journal, we can jot down our investment ideas, research findings, buying and selling prices for each stock, cut loss points, reasons of buying or selling the stocks, emotional expressions or feelings, and physical responses when we buy them. It should be noted that the journal should not be served reporting functions or be used to vent our frustration. If managed wisely, a good journal does not only allow us to review our decisions, know our states of mind, spot patterns, examine our competency, reflect on our mistakes, and prevent us falling into the same snares in the future, it also helps us discover ourselves through the "psychological mirror" and connect us to our inner world, including our wisdom, and objectives in life, and enhance our learning. By understanding ourselves better, we can refine our investing rules, and formulate a suitable strategy, and form a comprehensive checklist that could guide us better in our investing journey.

"*Keep an investment diary and re-read it from time to time but particularly at moments when there is tremendous exuberance and also panic. We are in a very emotional business, and any wisdom we can extract from our own experience is very valuable*."

Barton Biggs

4.2.10 Build Your Mental Strength

"*Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgement is sound, act on it – even though others may hesitate or differ*."

Benjamin Graham

By now I am sure you know the importance of having good investing principles. But not everyone has the ability to stick to their golden rules. People always find themselves having difficulty resist to the temptation of following the crowd to buy hot stocks when the market is in great excitement. Unless you intend to jump off the cliff with other lemmings, you should impose self-control in investing. We must stop the gambling behaviour. It is akin to playing Russian roulette. We would get "killed" in investing if we do not control our involuntary

behaviour. The important thing is to avoid falling prey to hot-hand fallacy. In investing, winning the first and second bets does not guarantee further success in the next attempt. We would ruin our financial life if we place our wagers without ensuring that the odds are in our favour.

When the market takes a nosedive, we must use our mental power to control our emotions, remain upbeat and stay calm even after suffering some losses. Stick to our investing rules and keep improving them. Our rules are the only weapon that can help us accumulate wealth in investing. Paying attention to the fluctuation of stock prices will not make us rich. Of course, we still need to have the courage to pull trigger when opportunity arises. The ability to execute a trade timely with conviction is essential to successful investing.

In addition, we must resist to trade when we are in emotionally unstable mood – be it thrilled, regret, angry or depressed. For example, in a rising market, we may be elated when our holdings are in a profitable position, and we will have an inclination to buy more shares regardless of their value. The influence of our emotions, which always hinders our investing success, will be put in check if we learn how to handle them well. Have a nap when we feel tired and take a deep breath when our brain is starved of oxygen or when we feel stressed. We would have difficulty to make rational investing decisions if our brains are overloaded. If we learn to tap our body's self-healing mechanisms to help us stay clear headed before we make any important investing decisions, the likelihood of making high risk investments will be greatly reduced.

Whilst people are generally financially prudent when handling their hard-earned money, they have a tendency to spend extravagantly with the dividends and capital gains they earn from the stock market. No matter how good our performance is, the mental accounting pitfall would render the snowball effect futile if we do not control our mental properly by keeping the dividends and gains. Thus, we should not spend the dividends and gains that we earn in stock investments, unless we trade for a living. Keep the proceeds for the next bargain, so as to let the snowball effect creates its astonishment.

Last but not least, we must keep learning, reviewing our past investments and focus on improvement. Read more investing-related books when we are free. Benjamin Franklin once said "*an investment in knowledge pays the best interest*." By continuing to learn, we understand ourselves better. We will discover more of our weaknesses. Additionally, it expands the arena and façade areas of our Johari windows, and reduces our mental blind spots. Keep in mind that our learning does not end when we leave college. According to John J. Ratey, a clinical associate professor of psychiatry at Harvard Medical School, "*The human brain's amazing plasticity enables it to continually rewire and learn – not just through academic study, but*

through experience, thought, action and emotion." And "*genes and environment interact to continually change the brain from the time we conceived until the moment we die. And we, the owners – to the extent that our genes allow it – can actively shape the way our brains develop throughout the course of our lives.*" And with the determination to continue learning, and the perseverance for continuous improvement, we also can be as successful as Koon one day!

Chapter Summary

- **The Biggest Behavioural Problems:**
  - ✓ Allow emotions to take over rational thinking
  - ✓ Hate facts, but like stories
  - ✓ Herd behaviour and follow others blindly
  - ✓ Impatience
  - ✓ Hesitate to seize opportunity
  - ✓ Refuse to cut loss
  - ✓ Invest with wishful thinking
  - ✓ Value stocks in possession unrealistically high
  - ✓ Overconfidence
  - ✓ Reject opposite view
  - ✓ Overly focus on short-term performance
  - ✓ Refuse to admit mistakes
  - ✓ Poor self-awareness

Chapter Summary (Continued)

- **Solutions to Addressing the Mental Pitfalls**
  - ✓ Learn to understand yourself
  - ✓ Stick to your investing rules
  - ✓ Deliberation and hard-work
  - ✓ Maintain the discipline
  - ✓ Concentrate on the facts
  - ✓ Tap into your powerful intuition
  - ✓ Close the empathy gap
  - ✓ Maintain humility
  - ✓ Keep an investment journal
  - ✓ Build your mental strength