Learning the Investment Game

Investment and speculation in the stock market involve assuming risk. If there is no risk because everyone knows something, it will have already been priced into the market and there will be no opportunity to make profits. Profits in investing come from savvy investors who make better assessments of risk than other investors, who may not really know what they are doing. The key then is to take on an appropriate level of risk in order to earn a return.

The general rule is that returns will tend to be higher when the risk of loss is greatest and lower when there is a very low risk of loss. However, that is not useful in investing. It would be foolhardy to scout around for the biggest risks and invest blindly in those stocks. What actually needs to be done is to make a more realistic assessment of the risk than other investors. This requires knowledge, hard work and skills that are born out of experience. So experienced and savvy investors will tend be better than beginners.

The other aspect of the problem is that when investing and speculating, investors have to make decisions about what might happen in the future. The future is inherently uncertain and difficult to forecast. Some gurus will profess to be able to predict the market, but all my experience from over 50 years as an investor indicates that they cannot. Sure, they make lots of predictions. If they make enough predictions, sooner or later one may turn out to be correct. That is the one the gurus talk about, but never mention all the wrong predictions.

Sandra went to a talk being given by one of these gurus. The guru outlined a method that seemed strange, but the guru was able to point out many of his predictions that had turned out to be correct over many years. Sandra was convinced and bought the expensive seminars that would teach her the guru's methods. Then she made her own calculations and invested some of her savings. She lost nearly half of her savings when her prediction turned out to be false.

So, Sandra went back to the guru, who told her that it takes time to be good at predicting and to persevere. Sandra did that and lost more money on each investment. This looked much more difficult than the guru had made out. At this point, Sandra talked with an experienced friend, who took a very sceptical view of the guru. Her friend suggested that she ask the guru to show his own audited investment results over the years when the guru's predictions were supposed to have been correct. The guru refused on the basis that this was private information.

Sandra's lesson here is that if something seems too good to be true, it is probably a scam. She also learned that in future, if gurus would not show their own investing results up front, she would not buy any seminars from those gurus.

So, in investing there is no single easy way to learn the craft. There are no short-cuts. It takes a lot of knowledge and experience to become a seasoned and successful investor. Most people will not be prepared to put in the time and effort. Even if they do, their personality may not be suited to investing.

If it is necessary to be knowledgeable and experienced to succeed in investing, we might think that this would mean that those who are less expert would exhibit the most uncertainty and therefore

Copyright © Colin Nicholson

display the most caution. On the other hand, we might expect those with the most experience and knowledge to be more certain about their judgements. The reality tends to be the opposite. Many experts will tell you that the more they have learned the less certain they are about anything. Beginners will be observed taking high risks, blissfully ignorant of what they don't know.

Most people, regardless of their knowledge and experience are what psychologists call ***overconfident***. In its most simple terms this means that we tend to be more certain we are right about something than we should have been when the facts become known. If someone asks us how certain we are about a share that we have decided to buy, we are likely to be falling into the overconfidence trap if we feel that we are anywhere near 100% certain.

After her bad experience with the guru, Sandra decided to educate herself in investing. She started with free courses run by the Australian Securities Exchange. She played the share market game that taught her a lot about her own personality without losing any real money. However, this was not enough.

Once she had done all of that, Sandra set about gaining real experience by making small investments, such that she did not lose too much while gaining experience. Twelve years later, Sandra became far more consistent and was able to manage her financial planning such that she would have a comfortable retirement.

However, while gaining this practical experience, Sandra went through a severe learning experience. The more she had learned, the more confident she became. Yet still she lost money. Again her friend came to her rescue and pointed out that her confidence was false. Sandra was only seeing one side of the question. Her last lesson was to always see the opposite view before making a judgement. Sandra had naturally found comfort in people who agreed with her. She was less comfortable with the friends who seemed unduly negative about her analysis. The final leap for Sandra was to stop seeking confirming views, but treasure opposing views. Then she would make a more balanced assessment and started to make far more money in the markets.

Sandra's initial overconfidence was due to several traits that tend to be present to some extent in most people. Although there are the meek, who may become rich from investing as well as inheritance, most people vastly over-rate their own ability compared to other people. Research has shown that this tendency is more evident the ***less*** we know about something and the ***weaker*** we are intellectually. So, if you are new to investing, or find investing difficult to understand, remember that a little knowledge tends to be dangerous psychologically.

One of the aspects of an inflated sense of superiority over others is that everyone tends to find it very difficult to imagine the full range of possible outcomes from a situation and just how many options they may have to deal with the problem. When experts are asked to forecast prices at some future time, many of them simply project the present trend into the future. Sometimes this works, but more often there is some change in the trend and the actual price may fall outside the range of their forecasts.

The best single antidote to overconfidence is to see the other side of the question before making a judgement. Take a page and rule a line down the centre. On the left, list all the reasons why you have decided to buy a stock. Then, on the right hand side, list all of the reasons that you can think of why someone would sell that stock to you. If you cannot list these reasons, keep thinking and analysing. If you still cannot list some negative views, seek out an experienced person who can assist you to see the other side of your decision. Then comes the difficult part: weigh everything up

Copyright © Colin Nicholson

and see whether you still want to go ahead. This works in all aspects of our lives. Mostly, we can do it in our heads, but when investing real money is at stake. It is best to do the analysis on paper until we are far more experienced.

Something that is becoming more and more evident in modern society is a totally unfounded belief that we have the wit and power to control random events. Much of what happens in markets is random and unpredictable, especially in the short term. Recognising this and devising an investment method that is based on it is a major step to avoiding the effects of overconfidence.

Confidence is an important ingredient in success of almost anything. If you have too little, you will tend to underachieve. But if your level of confidence is higher than is realistic, you are also likely to invest too often and to perform less well, losing money as an investor. The first guideline to dealing with overconfidence is to recognise it and be very cautious when you are confident about something about which you are not knowledgeable and experienced.

Finally, a reminder of the most important strategy discussed above: In investing, there is always someone on the other side of your decision. They have an opposite point of view. Seek out what their opinion is and the arguments supporting it. Weigh them up against the arguments in favour of your decision, and you may find your level of overconfidence becomes less. It will be more realistic and you make better investing decisions.

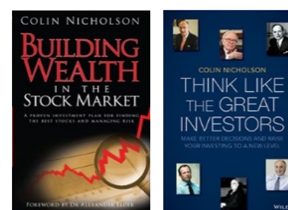
To read more of my work

Previous Articles

All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

Books

I have written two books, of which only *Think Like the Great Investors* is available for purchase from the ***Buy Books*** menu of my website. *Building Wealth in the Stock Market* is available at a very good price from Amazon:



Building Wealth in the Stock Market – A proven investment plan for finding the best stocks and managing risk

Think like the Great Investors – Make better decisions and raise your investing to a new level

Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website

Copyright © Colin Nicholson