Sharpen Our Investment Decisions

If we were to approach every investment decision in a totally rational way, how would we go about it? In theory, we would follow these steps:

- We would define the problem to be decided. This would be done as precisely and completely as possible.
- We would make a wide-ranging list of options that are open to us. At this stage, we would not make any conscious judgements between the various options.
- We would then list the criteria on which we will assess each of our options. These should come from our formal investment plan. Each criterion is likely to have a different level of importance in the overall decision.
- We would then assess each of our defined options, ideally with a numerical score that can be totalled to indicate which one of them is the best option.

If we were to do this, it should theoretically lead to us making an optimal decision, at least to the extent of our knowledge of the available options and the quality of our assessment of them.

However, most of us rarely, if ever, do this. To the extent that we fall short of the ideal, our decisions are likely to be less than the best solution. The reason that we do not follow the rigorous process described above, which should find the optimal answer to a problem, is because it is difficult to do. There are two main reasons for this:

- This process will take real mental effort and a lot of time to carry out, something that we tend to avoid. The more difficult or complex the investment problem, the greater the effort demanded to first identify and then sort out all the issues.
- Most of us, but especially less experienced investors, cannot easily and quickly come up with the full range of possible options. It is not that we are lazy; it is that we do not know enough about investing to see, or to be even aware of, all of the opportunities and pitfalls. Our list of options available to us will be only as good as our level of experience.

Instead, what we tend to do is to evaluate only the easy and obvious options and not consider alternatives that are more creative and that may be potentially very rewarding. In short, what we tend to do is to think only superficially about the problem and then take the easiest way out. So, as soon as we come across a solution that basically seems to satisfy our objectives, we are tempted to stop thinking and take that course. What we are doing wrong here is neglecting to spend the time and effort to consider other options which may present a far better result.

As alluded to earlier, a common reason why we accept something easy, without making a full search and evaluation of all the options, is because many investment decisions are very complex. There are a great number of factors to consider and it can be difficult to define them and carry out a full assessment of a wide range of options. Making it more difficult will be that many of the judgements we need to make in assessing the options are subjective. They are an assessment which is no more than our informed opinion. It is therefore quite natural for most of us to abandon any attempt at the rational process. Instead, what we do is to simplify everything. This might not be a good thing.

Consider James, a young and enthusiastic investor who is just starting out to learn the craft. He works in the retail sector and is good at what he does for a living. In order to simplify the problem of what stock to invest in, he decided to restrict himself entirely to retailers, so putting his day job knowledge to work in his favour.

Now, it may be argued that it is a good thing for James to have as an important part of his investment plan, if he has a formal one at this stage in his development as an investor. Even the great Warren Buffett says that he only invests in industries that he understands. However, Buffett understands more than one industry, while James is confining himself to only one industry.

This could be fine for the first few investments that James makes, but after a while he will have a portfolio that is not diversified across the economy. He will, in ignorance, have increased its risk level. If the retail sector is in a slump, as it has been in 2011, he will have not only have taken more risk than is ideal, he will have unwittingly carried a handicap, that may be much less if he had part of his portfolio in better performing sectors.

So, James starts out with a good idea, but carries it too far because he does not yet realise and understand the full ramifications of the well-established principle of diversification across at least some range of sectors.

Nevertheless, there are circumstances in which simplifying a problem is a good idea. It is quite justifiable providing that the decision is a simple one, what is at stake is not very important and when the decision can be easily changed.

It is not a good idea, though, if our view of the issues is superficial, such that we overlook vital considerations, as we saw in James' approach to building his investment portfolio.

Even more insidious is the tendency to accept the first acceptable solution we find, which is easy, but means that we stop working on the problem and never consider options that may give a far better outcome. Nor do we learn much from the experience.

If we would like to train ourselves to make better investment decisions there are three guidelines that I have found will help to avoid the trap of accepting an easy answer without looking for the best one.

Guideline one: avoid simply adopting the first solution that comes to mind

It is very useful to make a point of consciously making a list of all the alternatives we can come up with before starting to evaluate any of them. Avoid the temptation to quickly dismiss an idea before investigating it fully. In particular, we should try very hard to come up with ideas that are outside the square, or not our usual and obvious options.

It can be useful to ask more experienced and trusted advisers to make suggestions that you should consider. The danger in this is that you are simply given one solution that your adviser has first come up with. This does not get us very far. We should choose our advisers carefully with this in mind and stress that we do not want answers; we want ideas to investigate and to learn from the exercise.

Guideline two: assess every option fully before making a decision

Our key here is to make a conscious effort to put in the time to think through and to score each option against the various criteria we have listed. While we should look for the option that scores best in total, it can also be very useful to make a list of advantages and disadvantages for each option and assign positive and negative scores to them.

Guideline three: use the method of seeking a devil's advocate

Our idea here is to ask someone else to try to argue against your final choice. This provides a very powerful test of our decision, increasing the chances that it might be the best one.

However, there is an important caveat here. The key idea is that the devil's advocate is able to take an independent view. Above all, we should stress to our devil's advocate that we do not want agreement with our decision; we want them to test it by putting up arguments that might be ranged against it. We should all try this idea to gain an idea of just how powerful it is.

A shorter version of this article appeared in AFR Smart Investor magazine in October 2006 with the title A Devil's Advocate Sharpens Decisions.

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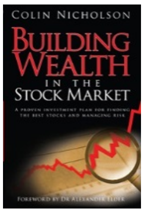

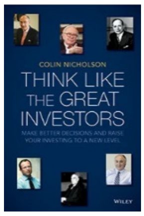

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