Wagner Road Capital Management

The Four Sources of Investment Mistakes

January 6, 2022

One of the most challenging parts of investment research is accepting when something has changed. There is a natural attraction to committing to a conclusion and *then* coming up with reasons for why you are right. This is never a good way to make any decisions, but investing on this basis is almost guaranteed to lose money.

An even bigger problem is getting rewarded for making bad trades. A string of big wins can create the false confidence that a strategy is working. Like a driver who speeds too much, pushing the limits of every corner will lead eventually to a crash. This is the type of behavior that has concerned me for the past two years.

I don't have any broad data, but I've seen and met speculators who made very risky trades betting on one spectacular event. The ones who lose money often knock themselves out of the game—sometimes they lose everything. The ones who make money decide to do it again. If they make money again, then they keep going, each time doubling down on their confidence. It works, until it doesn't.

This is not just a problem for speculators. It's a challenge for investors of every type for every time horizon. And the past decade has represented a unique economic experiment. Anyone who began their investment career after The Great Financial Crisis does not know a "normal" market. The response to that crisis is still somewhat ongoing—the interest rates that we've seen, along with government tax and spending policies, are still supporting a recovery, even without considering the impact of COVID-19.[1] This is part of the reason why "growth" stocks have dramatically outperformed traditional "value" stocks. The hardest question for investors is asking how much of their returns come from skill and how much comes from sitting on the right side of a lucky trend.

The answer doesn't always matter. The most important thing is the willingness to ask that question in the first place. Because asking that question helps improve the investment process. And this is how I introduce pieces of psychology into my investment models. It's how I think about thinking.

I look at making decisions with the intention of avoiding bad choices. There is always the need for balance (we have to take *some* risks), but avoiding bad choices is the best

[1] This comment is not a criticism or praise of any particular policies, only a mention that they continue to affect investors.

place to start. And they come from many sources: What we see is not always what is real. Sometimes we are distracted by unimportant details or skip over important ones. Sometimes we make connections that don't exist. And sometimes we are just too tired, too excited, or too busy to pay proper attention. It can be very difficult to take actions that are deliberate, purposeful, and consistently methodical.

It can also be very difficult to recognize when a choice might be a mistake. With stock market investing, it can take years for an investment thesis to be confirmed or disproved—and that includes the possibility of making money on a bad investment or losing money on a good one. It takes tremendous patience just to wait for a result. The best we can do is make sure that our selection process is comprehensive. Part of that involves having the right temperament.

From years of reading about psychology, I've combined descriptions of psychological bias into my (self-defined) four basic sources of investment mistakes:

- Miscalculations
- Avoidance
- Social-Emotional Pressures
- Physical Limitations

Miscalculations can always happen when you try to predict the future.

You can do the math correctly and still come to the wrong conclusions when you use the wrong process or start with the wrong assumptions (also known as "garbage in, garbage out"). Sometimes, even the way the information is presented, or "framed," can influence a decision. This means using inappropriate comparisons, too narrow of a focus, too much value on the future or the past, or simply too much confidence.

In psychology, miscalculations often come from too many mental shortcuts. Sometimes these shortcuts are necessary for making a faster decision, but it can cause us to miss important details. But even without a shortcut, a miscalculation can still come from a misunderstanding of statistics, by finding patterns where none exist. It is very difficult to recognize a miscalculation. Sometimes a re-calculation is necessary.

Avoidance is resistance to change.

It is not entirely bad, but it can be dangerous. This is where you think about that line between having conviction and being foolish. If you are avoiding new information, or refusing to re-evaluate any past choices, then you risk making the same mistakes many times over. This problem can become even bigger if you are actively seeking new information and re-evaluating past choices, but avoiding any evidence of mistakes. Reflection must be comprehensive.

Social-Emotional Pressures come from the fact that we take information from social sources and we can't escape the influence of our emotions.

Some of these pressures are connected to miscalculations, but they are also the result of an emotional response. In many cases, it is a reaction to the fear or the anxiety of ambiguous information. When the information is incomplete (as it always is with investing), emotions and social settings provide a guide. We like to do things that make us feel good and make us feel like we are not alone. If everyone else is doing it (and being successful), then it feels like it must be the right thing to do. On the other side, the fear of losing and the fear of missing out (FOMO) are also incredibly powerful.

Even the most stoic and independently-minded people can be affected by this kind of pressure. But information must be evaluated on the merits of the facts and the credibility of the analysis, not just the authority and the appeal of the person presenting them. We have to trust ourselves, but we have to doubt ourselves too.

Physical Limitations describe how the limitations of being human can magnify the challenges of making good choices.

The main theme of these limitations is the connection of the body to the mind. Whenever you have low energy, whether from being tired, or sick, or stressed out, then you are much more likely to make mistakes. There are also specific connections to how different diets, lifestyles, injuries, or natural chemical interactions can affect brain function—and also affect the way we think, making the other three sources of mistakes more powerful.

This can be a difficult part of making good investment decisions because it is often hidden. We can be influenced by physical changes just as much as different emotional states or social settings. An obvious example is that no one should be trading after they have a few drinks. These kind of physical limitations require spending some time on physical (and mental) health. A healthy body is more likely to go along with a healthy mind, and a healthy mind is more able to resist the challenges of making good choices.

What to do about it?

The combination of many separate biases and influences can lead to extreme results. However, there are some common ways to make mistakes less likely:

- Finding more information.
- Eliminating or changing comparisons.
- Separating how you feel about someone from the information they provide.
- Getting an outside opinion.

- Limiting major decisions to a time when you are physically and mentally prepared.

All of these approaches can be simple and helpful, but there is one thing that I feel is the most important for making good investment choices—when the facts change, change your mind.

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