Fighting against our instincts

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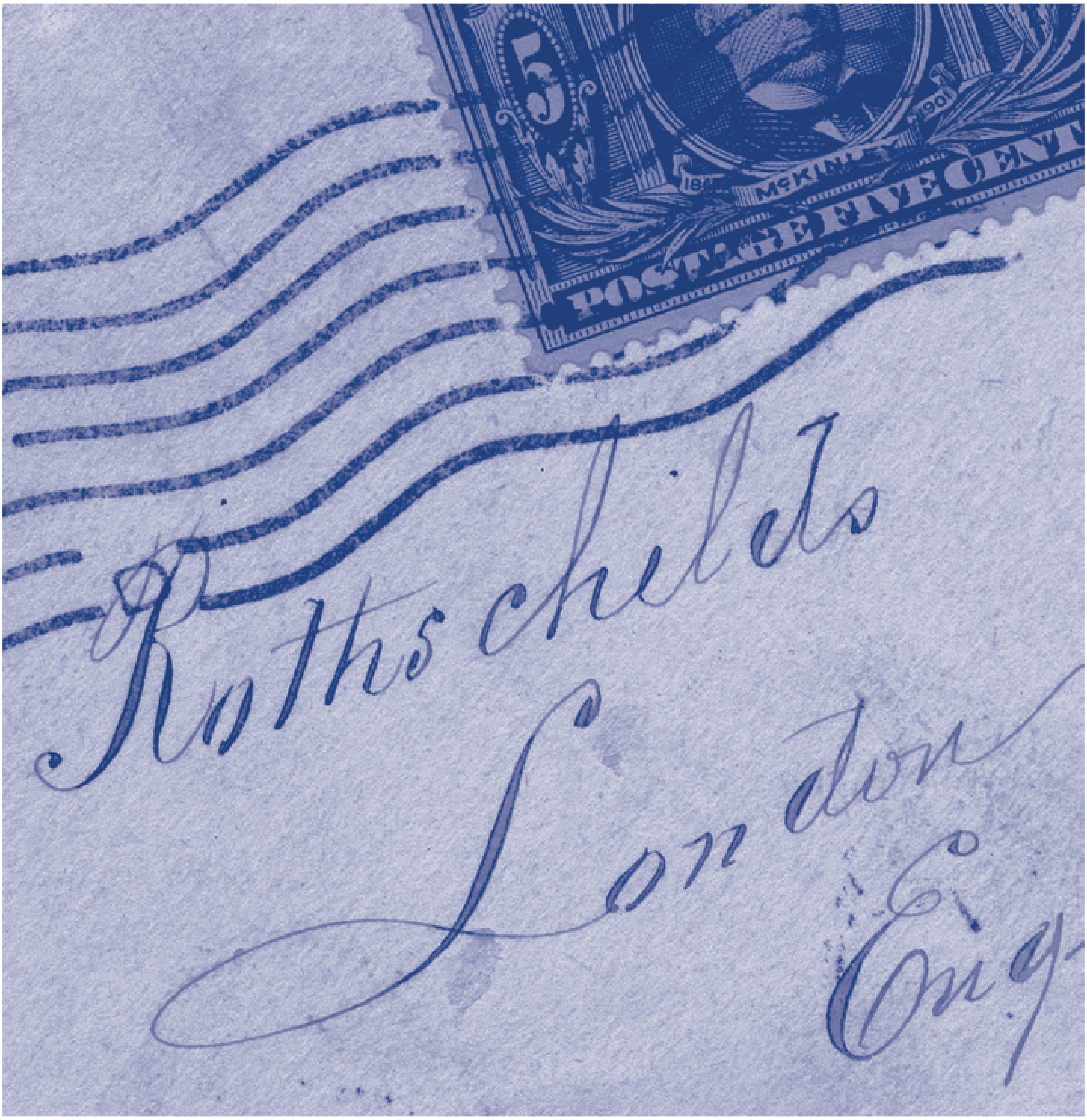

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Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904.
Courtesy of The Rothschild Archive

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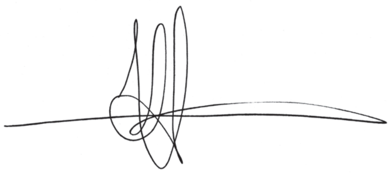
Foreword

Over the summer, the Bank of England's chief economist Andy Haldane grabbed the headlines with his warning that artificial intelligence (AI) threatens to replace a huge number of jobs. Haldane is not alone in expressing concern about the disruption that AI could cause. However, it is important to observe that the jury is still out on what impact the rise of the robots will have.

The more we attempt to make technology replicate human thinking the more we realise how remarkably complex the human mind is. Machines remain poor at picking up on cues in the wider world that humans instinctively react to and process – not that we are necessarily aware of what is going on. Instinct and unconscious biases play a much bigger role in our thinking and behaviour than many of us recognise, or would care to admit.

That extends to the way we invest, and that's not necessarily a good thing. As we explain in this Quarterly Letter, biases built into human DNA can all too easily lead to investment mistakes, which is why we have been working hard to make sure we identify such biases and counter them as best we can.

Coincidentally, Andy Haldane is a member of the Bank of England's Monetary Policy Committee, which in August voted to increase the base rate from 0.5% to 0.75%. One of the many benefits of having longevity of employee tenure is that our team were in place when interest rates were last at 'lofty' levels, more than 10 years ago. As a result of this increase in rates, we have begun to pay interest on cash in portfolios. If you would like to know more about how this affects you, don't hesitate to get in touch with your client adviser. In the meantime, I hope what follows gives you lots of food for thought, and thanks, as always, for your continued support.



Helen Watson
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Fighting against our instincts

Let's start with a puzzle. An individual, chosen at random, has been described by a neighbour as follows: "Steve is very shy and withdrawn, invariably helpful but with little interest in people or in the world of reality. A meek and tidy soul, he has a need for order and structure, and a passion for detail." And now a simple question: is Steve more likely to be a librarian or a farmer?

Chances are that you didn't have to think for long. Words like "meek" and "shy" are ones we associate with librarians not sheep-shearing, tractor-driving, tough-guy farmers.

But, wait a second. Think about it more carefully, and from the information given there is no way of accurately determining Steve's profession. We are jumping to conclusions based on scant evidence and crude stereotypes.

Next, consider this: there are many more farmers in the world. In the United Kingdom, for example, there are about 15 times more farmers than librarians.[1] Not all of those are going to be men – the available data for the UK doesn't break down by gender. However, there is a higher statistical chance of Steve being found behind the wheel of a tractor than an information desk. Even if he is a "meek and tidy soul", assuming Steve is more likely to be a librarian is logically a mistake.

The above is just one example of the many thought experiments[2] conducted by two trailblazing Israeli psychologists who fundamentally changed our understanding of the way we think and the choices we make. By highlighting the systematic errors, or so-called behavioural biases, that influence our decisions, the work of Daniel Kahneman and Amos Tversky has had a profound impact on economics and the way we at Rothschild think about investment.

To be a successful investor over the long term, we believe it is necessary to be aware of the biases that often lead to poor decisions and, where possible, counteract them. Kahneman and Tversky's groundbreaking work is one of the reasons why we spend a lot of time thinking about and trying to improve our own investment decision making – but more of that later.

Challenging established thinking

Although not economists themselves, Kahneman and Tversky's work helped to revolutionise economic thinking, leading to the emergence of a new discipline called behavioural economics. It is a branch of economics that has been getting a lot of attention recently, after a leading practitioner in the field, Richard Thaler, won a Nobel Prize for his work in 2017.

Kahneman himself was awarded the Nobel Prize in 2002 for work that laid the groundwork for behavioural economics. Yet, despite this acclamation, it has taken decades for the discipline to enter the mainstream.

The origins of behavioural economics date back to 1969 when Kahneman and Tversky first met. At that time, the standard neoclassical economic view was that human beings were smart, rational creatures. Theories were built on the shoulders of the idealised economic human being, "Homo economicus", a wealth maximiser who always acts in his or her (at the time it was mainly his) best interests.

Kahneman and Tversky challenged that view, revealing that humans do not always act rationally in the sense that classic economic theory predicted they will. Once you start to look, you don't have to dig very deep to uncover evidence to back up that theory. Who, after all, hasn't been tempted by that carefully placed chocolate bar near the supermarket checkout, even when you promised you'd stick to your diet and know it's not good for you? Can you truly admit that you have never judged someone's comments more favourably because they are more attractive than the next speaker? Think about it: there is no need to blush, it's just the way our minds work.

Even though much of our decision making is not rational, it doesn't mean that the choices we make are random. Kahneman and Tversky's research programme demonstrated that we often exhibit the same behaviour in the same situations. But, even if we do make the same mistakes time and time again, it doesn't follow

[1] 21,286 librarians to 294,000 farmers.
Sources: OCLC: Global Library Statistics, 31 May 2018; gov.uk: 'Agriculture in the United Kingdom 2017', 17 July 2017.

[2] Daniel Kahneman: *Thinking, Fast and Slow*, 2011.

through that we recognise what is going on. We are often so absorbed in our routines that we don't even give it a thought.

As the behavioural economist Dan Ariely puts it in his book *Predictably Irrational: The Hidden Forces That Shape Our Decisions*: "We usually think of ourselves as sitting in the driver's seat, with ultimate control over the decisions we made and the direction our life takes; but, alas, this perception has more to do with our desires – with how we want to view ourselves – than with reality."[3]

If we fail to recognise when our decision making is flawed, or seek to explain why, we can be doomed to repeat the same mistakes. With that in mind, let's explore the biases that are most likely to affect our – and your – decisions about investment.

Anchors are all around us. If you consider how much you will pay for a house, you are influenced by the asking price. When investing, values such as market index levels or past share prices often act as anchors.

Information overload

Earlier on when we were thinking about Steve, the problem we faced was having too little information to make a rational decision. However, investors often face the opposite problem, too much data.

When that happens, information bias encourages us to focus on news and views that are often useless to understanding a situation and making a good decision. Investors are bombarded with such information every day, much of it focused on the latest share price or market movements. They take notice of this data as they mistakenly believe that the more information they collect, the greater the chances of beating the market.

Uncritical thinking

Part of the problem is that we kid ourselves that we carefully gather and evaluate information and data before coming to a conclusion. We don't. According to Kahneman[4], contrary to the rules of philosophers of science, who advise testing hypotheses by trying to refute them, we seek data that confirms the beliefs we already hold. We miss, ignore or dismiss information that contradicts those beliefs.

Confirmation bias is why we tend to buy a newspaper, or read and like social media posts, that confirm our view of the world. It also explains why conspiracy theorists who believe, say, that man never walked on the moon, can put forward lots of supportive evidence and ignore information that disproves their claim.

In the investment sphere, confirmation bias can lead to overconfidence and a false sense that nothing is likely to go wrong. It means you can be blind to new and vital information that changes an investment base case. We'll search for information that confirms our view and ignore any that disproves it.

Irrelevant anchors

In the face of uncertainty, people will cling to any irrelevant information when making decisions, estimates or predictions, particularly a number. This is known as the anchoring effect, as any estimates will stay close to the number given, the 'anchor'.

One of Kahneman and Tversky's most celebrated experiments involved a rigged wheel of fortune, marked from 0 to 100 but built so it would stop only at 10 or 65[5]. Volunteers were asked to stand in front of the wheel and write down the number at which the wheel stopped, which of course was either 10 or 65.

They were then asked to guess the percentage of African nations in the UN. The ones who saw the wheel stop on 10 guessed 25%, on average, and the group who saw the wheel stop on 65 guessed 45%. The volunteers' answers were influenced by the completely irrelevant wheel of fortune.

This is well worth remembering as anchors are all around us. If you consider how much you will pay for a house, you are influenced by the asking price. When investing, values such as market index levels or past share prices often act as anchors.

Value judgements

The ingenuity of the research conducted by the founders of behavioural economics is often startling. In 1990, Thaler, he of the Nobel Prize, teamed up with Kahneman and economist Jack Knetsch to conduct an experiment involving students and coffee mugs.[6]

They randomly handed out free coffee mugs to half of the students and asked those with mugs how much they would sell them for, and those

[3] Dan Ariely: *Predictably Irrational: The Hidden Forces That Shape Our Decisions*, 2008

[4] Daniel Kahneman: *Thinking, Fast and Slow*, 2011.

[5] Daniel Kahneman: *Thinking, Fast and Slow*, 2011.

[6] *Journal of Economic Perspectives:* 'Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias', winter 1991.

without mugs how much they would pay for them. Their hypothesis was that the students with coffee cups would value them more highly, and that's exactly what happened. The median price demanded by the undergrads with cups was $5.25, while the median buyer didn't want to pay more than $2.25 to $2.75.

Thaler called it the endowment effect: people ascribe more value to things simply because they own them. Again, this can be related to the world of investment, where investors are often less willing to sell a stock that they have owned for a long time. Through ownership they become invested (no pun intended) in that stock.

The endowment effect is also linked to another bias called loss aversion. Kahneman and Tversky have argued that the pain of loss is felt roughly twice as strongly as the pleasure associated with a gain.[7] Investors hang on to investments that have lost them money, even if the evidence suggests that they have further to fall, because they cannot cope with the regret of making a loss. As Kahneman asserts, the "fear of regret is a factor in many of the decisions that people make."[8]

Keeping consistent

Another reason why we may be reluctant to change our view is our desire to appear consistent. We associate consistency with intelligence, rationality and stability. On the flip side, we tend to perceive people who are inconsistent as confused, lacking in intellectual rigour, even dangerous.

This leads to consistency bias, the tendency to want our actions and thoughts to be seen as coherent. Change is generally not seen as consistent, which can make it difficult to alter our position even when faced with better information.

Allure of the new

So far, we have seen that our psychological makeup encourages us to strive for consistency, even if it is not in our best interests, ascribe more value to things we already own and fixate on information that is either useless, irrelevant or confirms what we already think. To this catalogue of biases we can add a disposition, when making decisions, to give much more weight to recent events or observations.

Known as recency bias, it is why investors often focus on short-term share price moves and fund returns, rather than regularity of returns over the longer term. It also explains why investors rush to buy when stock markets are near their peak and panic sell when markets are at their bottom – exactly the opposite of what they should be doing. Recency bias leads investors to assume that the recent performance of the stock market will carry on, even in the face of dissenting evidence.

Deep in our DNA

So, those are some of the most important biases that Kahneman and Tversky identified, but why do we behave in this way? There continues to be a fairly heated academic debate about why so many of our decisions are driven by emotion, instinct and intuitive thought rather than deliberate rational reasoning. However, a theory that is now widely accepted is that our genetic inheritance plays an important part.

The biases we display appear to be evolutionary adaptations that helped our ancestors to survive. For example, losses have been shown to trigger activity in the amygdala, one of the most ancient parts of the human brain.[9] The amygdala may have helped early humans survive in potentially life-threatening situations by triggering emotions of fear and anxiety.

This leads to consistency bias, the tendency to want our actions and thoughts to be seen as coherent.

Our brains, it seems, were well-designed for survival on the African savanna tens of thousands of years ago. Unfortunately, that doesn't mean they are adapted to achieving success in activities we face today, including investment.

If, as many suspect, behavioural biases are hardwired into our DNA, it may be impossible to completely negate them. However, we believe that by being aware of the biases and acknowledging their effect, a step that many investors never take, it is possible to minimise the negative impact.

Overcoming instinct

At Rothschild, we have attempted to create an environment to overcome, or at least counter, the flawed thinking that gets in the way of good decision making. This involves encouraging rigorous debate, adopting a scientific mindset and checking all our decisions for biases.

An example of our approach in action is provided by our recent sale of Colgate-Palmolive. We purchased shares in the US consumer-goods giant, best known for its toothpaste, in December 2016.

[7] Daniel Kahneman: *Thinking, Fast and Slow*, 2011.

[8] Daniel Kahneman: *Thinking, Fast and Slow*, 2011.

[9] *Scientific American*: 'What is Loss Aversion?'

As with every other company and fund we buy, this prompted us to write a ‘road map’ for the business, detailing our rationale for the investment and how we expect the business to perform in the future.

Colgate-Palmolive has an impressive global footprint, with emerging markets accounting for more than 50% of revenue. Back in 2016, one of our key reasons for investing, and central to our roadmap, was an expectation of continued strong sales growth in emerging markets.

However, by late 2017, our thinking had begun to change. We had started to question whether the growth from emerging markets would be as strong as we had previously predicted. At that time, the road map helped counter a number of biases including recency bias (“the share price has gone up, so that’s a positive sign”), endowment effect (“we only recently bought the stock”), confirmation bias and consistency bias. We conducted further work and ultimately decided to exit the position in full.

Checking for biases is an established part of our process. After we have made a decision to invest in a company or fund we unpick how we came to that decision. We ask ourselves whether any biases influenced our thinking.

Spirit of inquiry

As this demonstrates, checking for biases is an established part of our process. After we have made a decision to invest in a company or fund, we unpick how we came to that decision. We ask ourselves whether any biases influenced our thinking. While the outcome of this analysis is unlikely to change our opinion about whether to invest or not, it is used to try and improve our process and help counter biases when we make future decisions.

Our team structure, which ensures that any investment decision is the result of collaboration between portfolio managers and analysts, means that views are constantly challenged. This thinking is also one of the reasons why we usually assign two analysts to each company we follow. In the process, we aim to counter systematic errors such as information, confirmation and recency bias.

To encourage open debate and collaborative decision making, our analysts present information available as is, rather than constructing a for or against argument for investments. The latter approach, common in the investment world, would force our analysts to cherry-pick data to back up their individual view, potentially leaving biases unrecognised.

In addition, only after we have gathered all information and views internally will we seek views from our external network of highly-valued third party managers and experts. This makes the whole decision-making process more rigorous and transparent.

We don’t kid ourselves that behavioural biases which have been ingrained in the human decision-making process for tens of thousands of years can ever be completely beaten. However, by at least being aware of these biases and setting up systems to recognise and counteract them, we give ourselves a better chance of success.

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.