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Are you a smart investor? Time for a reality check.

Devina Mehra | 28 Aug 2024, 02:00 PM IST

When you attribute every investment success to great analysis and skill and every failure to bad luck, the result is over-confidence.

SUMMARY

We have a tendency to attribute investment success to our skills and failure to risks and factors beyond our control. It's a natural bias that boosts our self-esteem as investors and helps us persevere. But this is a game of both luck and skill, and those who resist biases are likelier to win.

If you are an average investor in the Indian stock market, I am sure you must be feeling pretty smart just now. After all, in the past year, the Nifty 50 is up around 30%, the NSE 500 40% and the Smallcap Index a whopping 60% plus.

I am sure you have stories of how you looked at financials, management, etc, and identified this stock a year or two ago which is now up three or five times. You are likely very pleased at having finally learnt this stock market game.

Now let us go back some 20 months to the beginning of 2023. Would you have felt as smart then? To recap, in 2022, the Nifty returned 4%, about half the typical fixed deposit rate; the Smallcap index was down, and if you had invested in Nasdaq exchange traded funds (ETFs) and other funds launched with much fanfare in 2021, you would be staring at a 40% loss. Same if you had bought crypto assets or non-fungible tokens (NFTs) in the 2021 boom.

But then, you would say the 2022 disruptions were because of the US Federal Reserve raising interest rates, Russia invading Ukraine, the spike thereafter in commodity prices, supply disruptions and a thousand other reasons.

And God forbid, had you invested in small-caps during the 2017-18 boom, by the end of 2019, you would have been cursing stock operators, shady managements and the like because the Smallcap Index was down 65%, with many stocks down by 80-90%.

Do you see the pattern? We attribute outcomes to ourselves, but only if they're successes! As a thumb rule, we attribute successes to our skills and failures to risks and factors beyond our control.

And this goes far beyond investing. When we land a job, we believe that we have been hired for our talent, qualifications, past achievements and great interview performance. But if we do not get the job offer, it is because the interviewer was prejudiced or there was some other hanky-panky afoot. That is how the human mind works.

In investing, self-attribution means that if I pick a stock and it goes up, it's because I'm a genius. But if the stock doesn't do well, then it's because of external factors—like the central bank, economy, politicians, bad company management, stock operators, or maybe even a natural calamity.

There are always plenty of villains to blame. Always, success is because of my skill and the failure is because of some risk that could not be foreseen.

Most games in life, with the probable sole exception of chess, are games of luck plus skill. Investing is no different. However, investors weight the two differently, depending on how well they have done recently.

Thus, if you have done very well over the past year and are asked what proportion of your investment performance you attribute to skill, you are likely to give a much higher percentage than you would if your portfolio had not done well, in which case the luck or risk factor would have been rated higher.

Why does this bias exist? As with most cognitive biases, it exists because it had a role in human evolution. This one allows you to protect your self-esteem. By attributing positive events to yourself, you get a boost in confidence.

By blaming outside forces for failures, you are more likely to persevere even after a failure—whether it was a failed hunt or the inability to land a job.

Anything that boosts your confidence and self-esteem should be good, right? Only if you are in school! In the stock market, it can be a disaster.

When you attribute every success to great analysis and skill and every failure to bad luck, the result is over-confidence. Which in turn leads to taking on an inappropriate degree of financial risk, trading too aggressively, increasing the probability of poor outcomes, over-trading, et al. It can also result in concentrated portfolios because you're so convinced of the brilliance of your analysis.

All of these things are to be avoided. Equally important, not taking responsibility for your errors means that mistakes in thinking, frameworks, ways of analysis and so on will continue unchecked because you refuse to admit that there was anything wrong with your decision-making process in the first place. Thus, you're doomed to repeat your mistakes over and over again.

Remember the quote, “Don’t confuse brains with a bull market." When profits pour in during a bull run, it is all too easy to congratulate yourself and your outstanding analytical skills. And forget that most of your gains are due to the luck of being in a certain market at the right time.

This happens not just with lay investors, but even professional fund managers, who arguably have even greater incentives to do this in order to justify their fees.

Always remember that in both successes and failures, there is luck and there is skill. Your mind should not trick you into thinking that everything that does well was due to your skill and everything else was a case of “Poor me! I could not have foreseen that. Bad luck."

In investing, your decisions are always made with many unknown factors and hence there is always an element of luck. We remember bad luck or risk, but forget about the element of luck in good outcomes, unless we consciously look for it.

Our mind is great at playing tricks on us. But that’s a topic for another column altogether.

Devina Mehra is chairperson, managing director and founder of First Global, an Indian and global asset management company, and author of the forthcoming ‘Myths and Mantras: The Ultimate Investment Guide’. Her X handle is @devinamehra