Stop. Think. Invest.

What’s in it for me? Learn how to avoid common investment pitfalls.

The term behavioral economics may sound imposing, but it’s rooted in the simple fact that emotions and life experiences influence people’s decision-making. As humans, we each have a set of biases and fears that can be hard to shut off – even if we’re aware of the influence they have over us on a daily basis. Obviously, this applies to our investment decisions as much as anything else. Two Nobel Prize–winning economists, Daniel Kahneman and Richard Thaler, have championed the concept of behavioral economics over the years. The blinks to Michael Bailey’s Stop. Think. Invest. incorporate their insights, along with Bailey’s own knowledge gained from years of investment experience, to reveal how you can start making better decisions – whether you’re looking for your next opportunity or wondering what to do with the portfolio you already have. In these blinks you’ll learn

how being too close to a company can blind you to potential problems; how risk aversion and loss aversion can lead to bad choices; and why you never want to “set it and forget it.”

Behavioral economics can help you make better investment decisions.

For decades, investment opportunities didn’t get much safer than General Electric. What started as an electric lighting company in the late 1800s went on to become one of the most powerful and profitable conglomerates of the twentieth century. Everyone in America knew what the initials “GE” stood for, and even as the twentieth century was winding to a close, most investors believed that the company was in good hands and would continue to thrive. In late 2015, the former CEO of GE, Jeff Immelt, painted a rose-colored future of booming profits due to new cutting-edge power plants, health-care technology, and jet engines. Immelt even set the ambitious goal of seeing GE’s per-share price rise from $1.20 to $2.00 in three years’ time. Alas, it didn’t pan out that way. Instead, between 2015 and 2018, the price per share dropped to a heartbreaking 65 cents. Along the way, many investors stubbornly went down with the ship. Why? Behavioral economics. Investors were blinded by emotions and biases that prevented them from seeing GE as anything other than a safe and reliable bet. GE’s CEO presented investors with a narrative they saw no reason not to accept – even when warning signs were obvious to outsiders. Behavioral economics is the study of how the social, psychological, and emotional facets of human nature play into the field of economics and investing. It represents a combination of cognitive behavioral factors that should be considered when making important financial decisions – such as knowing which stocks to pick, when to sit tight, when to sell or trade, and how much to invest. Author Michael Bailey has identified 12 steps in the stock-picking process – along with 100 cognitive behavioral coaching tips – that can help steer you in the right direction. While we won’t get into the details of each and every tip, we will highlight one or two from each of the 12 steps so you can avoid the major pitfalls that have been known to sink even the most seasoned investors.

Narrow down your options with a mix of libertarian and paternal approaches.

Before we get into the nitty-gritty, let’s take a big-picture overview of the investment cycle. At its most basic level, investing is a process that involves the following: looking for new ideas, researching companies, mapping out your long-term expectations, deciding on the timing and size of your investment, making a purchase and analyzing the results, considering when or when not to sell, reevaluating your expectations, and focusing on learning and improvement.

With that in mind, let’s start with the steps of looking for new ideas and researching businesses. There’s no lack of options when it comes to investing. In fact, there are way too many out there to really consider them all. This is why the first investment tip is about how, sometimes, less is more. Some of the more traditional economic theories suggest that the more choices consumers have, the better off they are. But this isn’t necessarily the case. It’s not hard to reach a point where an abundance of choices can lead to what behavioral scientists call the paradox of choice. Basically, this is what happens when there are so many options that it becomes virtually impossible to make a decision. In his book Nudge, author and Nobel Prize–winning economist Richard Thaler talks about the role of a choice architect. This is an expert who can come into a situation and help teams and organizations who are facing a paradox of choice make better decisions. The process here is all about narrowing things down. Eliminating choices. Giving yourself fewer options. How exactly do you do that? According to Thaler, through a combination of libertarianism and paternalism. In this context, being libertarian means being open-minded – open to all ideas and free of opinions or biases that might blind you from the perfect investment opportunity. However, after you’ve looked at things with an open mind, you’ll need to narrow them down by exerting a certain amount of paternalism. That entails using your knowledge and exerting your influence to guide the selection process in a certain direction. Now, all of the advice we’re considering here is about long-term investments – not stocks you buy in the morning and sell in the afternoon for a quick profit. So, as a general rule of thumb, Bailey recommends seeking out stocks that have the potential to beat, or outperform, the market. One specific thing Bailey looks for when stock-picking is something he calls “secular change.” This might be a company that has changed management, made a sizable acquisition, created a new division, or perhaps launched a new product campaign. Secular change is not always apparent – but it has the potential to increase the value of a business and create the kind of beat-the-market opportunity you should be looking for. So let’s put this concept of libertarian paternalism into action, and look at how it led Bailey to discover a new investment opportunity. In 2016, Bailey took an open-minded, libertarian approach to looking for new long-term investment ideas. This led him to explore options like cloud computing, cyber security, and self-driving cars. From there, he shifted to a paternalistic approach and took a close look at these three different ideas. Self-driving cars still seemed a little too high-risk at the time. As for cloud computing, he already had holdings in Microsoft and Google – so he felt he had this trend covered. He narrowed it down to cyber security, an area that would likely continue to have long-term relevance in the market. This, in turn, led him to Palo Alto Networks, a company that was big enough to already be generating profits, but small enough that it could conceivably undergo change and rapid growth in the near future. Finding these opportunities isn’t exactly child’s play. It takes effort, which brings us to the next step: research.

Neutralize your biases by giving yourself a range of diverse options.

It should go without saying that research requires thinking. But did you know there's more than one way to think? As it turns out, there are two different ways: System 1 and System 2 thinking. System 1 is the passive thinking you can do when you're deep-scrolling on your phone, looking for something to watch on Netflix, or pushing your shopping cart down the aisles of a store while listening to a podcast. System 1 is kind of like autopilot thinking. System 2, on the other hand, requires more concentration. This is the thinking that demands your full attention. You can't multitask when you're engaged in System 2 thinking. That would be like trying to check your Instagram feed while navigating your car through downtown city traffic at night during a rainstorm. It wouldn't end well. Likewise, when picking stocks and researching opportunities, you don't want to be multitasking. You want to be fully engaged in System 2 thinking. Otherwise, you're bound to make mistakes. Another tip for this stage of the process? Make sure you don't end up being blinded by the inside view. Researching your options and getting to know the details of the businesses you're considering is a crucial part of the stock-picking process. And it can be incredibly useful to talk to people who are part of the industry. But you don't want to get so far inside that you lose sight of your impartiality. Sometimes, the inside view can be so rosy and full of optimism that it can lead you to making some really bad decisions. So remember to always take a step back and consider the outside view before drawing any conclusions. There are other common biases to be aware of during the research phase. One is known as the availability bias. This refers to our tendency to treat information that is readily available as more important, reliable, and relevant than information that is harder to come by. Don't hesitate to get out of your comfort zone and dig deep when researching your options. Of course, when talking about picking stocks, we need to mention risk aversion bias. If you're anything like most people, you have an inherent aversion to risk. Say you're offered a choice between a five-dollar refund, no questions asked, or a ten-dollar refund that requires a stressful conversation with customer service. Which would you choose? Probably the five dollars. Other studies show that losses are psychologically more powerful than gains. Specifically, there's a two-to-one ratio when it comes to how people feel about losing vs winning money. That is, you'd feel two times more upset about losing ten dollars than happy about winning the same amount. This might make sense when it comes to survival instincts – but, unfortunately, this aversion to risk can lead to some poor stock-picking decisions. The good news is, once you're aware of your risk aversion bias, you can take steps to neutralize it! First, simply remind yourself that safe bets are often bad investments. This also ties into the availability bias. A safe bet is likely one that everyone knows about – and if everyone knows about it, that stock isn't going to beat the market or do much for your portfolio. So a good tip here would be to give yourself a range of risk to choose from – or to find a way to mitigate the risk by broadening your framework. For example, when Bailey was looking at different tech-related stocks, he looked at low-risk cloud computing and high-risk self-driving cars. In the end, he chose something that had more mid-level risk: cyber security. But let's say you really wanted to get involved with self-driving cars. You could do so while lowering your risk by broadening your framework and looking at the different companies that are making self-driving cars possible. This could lead you to the company Mobileye, which makes specialized microchips for self-driving cars. Since Mobileye was acquired by the big tech company Intel, you may be more comfortable adding Intel to your portfolio.

Two great tools for better investing are an investment thesis and an investment committee.

At this point, it’s probably a good time to talk about writing – or “crafting,” as Bailey calls it – an investment thesis. Doesn’t that sound fun? OK, that was a rhetorical question. Nevertheless, this is a bit of work that will pay dividends in the long run. Crafting an investment thesis simply involves writing down your reason for picking the stock you decided upon. What made you choose this stock? What are your expectations? This is the time to exercise your rationality and lack of bias. Be clear and practical, and don’t let inside views or bold forecasts skew your judgment. Make sure you’ve gotten multiple perspectives and aren’t giving too much weight to unlikely events – or too little weight to likely events. In 2018, Bailey wrote an investment thesis for Amazon regarding their early efforts in getting into the online ad sales market. As Bailey saw it, Amazon was in a good position. Unlike Google and Facebook, who dominated the market, Amazon’s ad sales didn’t take customers away from their sites. Instead, Amazon simply targeted existing customers. In his thesis, Bailey did his homework by looking at the numbers for 2018 and saw rapid growth for Amazon in this area. But he was perhaps too optimistic in simply projecting that the growth would continue uninterrupted into 2019. Because it didn’t. Those online ad sales stalled in the first quarter of 2019, disappointing investors. However, the investment thesis had also considered Amazon’s e-commerce and cloud computing businesses, which were both strong enough to make up for the ad sales. That’s another tip: it’s good to create what Bailey calls a “three-legged stool” when crafting a thesis – a plan where the outcome doesn’t hinge on just one part of the company. A good investment thesis is priceless. It’ll not only help you figure out the right stock to pick, but will also help you make a number of other important decisions – like when to buy or sell. Another useful tool that goes hand-in-hand with an investment thesis is an investment committee. This is generally an impartial group of professionals who can help debate the pros and cons of an opportunity and make sure that a thesis or plan is realistic. Of course, groups can also be susceptible to biases and behavioral pitfalls. For instance, large groups tend to fall into the trap of becoming unnecessarily risk averse. So when it’s time to debate a decision, the smart move is to break the committee up into smaller groups. One final note: it’s human nature for people to fear punishment or reprisal when it comes to speaking up and contradicting someone who’s in charge. So it’s important to encourage everyone in the investment committee to be sharp, take notes, make observations, and speak up without fear.

Don’t let external influences like media noise push you to sell too early.

Let’s say you’ve done your research, written your thesis, consulted with the committee, and – without any further procrastination – made your initial purchase. Now what? Well, now it’s time to monitor and analyze the early results. But beware: this part of the process is also full of pitfalls related to human behavior. It’s likely that your new investment will get off to a bumpy start. It might drop sharply before it takes off and successfully beats the market in the long-term. So it’s important to keep things like loss aversion in mind. Remember that two-to-one ratio in which people feel disproportionately bad about losing a small amount of money? This kind of aversion has led many investors to making bad decisions in difficult times – and that's precisely what we want to avoid. When something goes wrong, it's easy for System 1 thinking to take over; you might latch on to the obvious and easily available information and make a rash decision. The key here is to fight back against that kind of reaction and engage in big-picture System 2 thinking. Take a deep breath. Now's the time to keep a cool head and really figure out what's going on. Sure, the stock took a tumble. But instead of hitting the ejector seat button, let's figure out why it took a tumble. There are a number of reasons why a stock could hit a rough patch. One common and unfortunate cause is the media echo chamber. A small, insignificant problem may arise and get reported on – which then causes a significant sell-off. This sell-off can snowball into another news item, which in turn fans the flames of panic even further. If you can recognize this particular feedback loop when it occurs, you'll gain some reassurance that the initial problem was, in fact, minor – and not cause for alarm. One good example of this involved stock in health insurance companies ahead of the 2016 US presidential elections. There were rumblings that Elizabeth Warren might win the presidency and overhaul the American health-care system. This caused concern that a single-payer program would be installed, making health insurance companies go bust. As a result, many people unloaded their stocks. Cooler heads recognized the plausibility and understood why the prices in heath insurance stocks were falling – but they also saw that the likelihood of all of those dominoes falling was pretty small. Even a recession can be weathered. (By the way, here's where a good investment thesis can once again come in handy!) In 2007, just before the major global recession, Bailey bought stock in a medical device company called Covidien. When Bailey bought into Covidien, it had just spun off from Tyco, a major conglomerate. This meant that Covidien was in a great position to experience rapid growth. While Covidien entered some choppy waters early on as the recession hit, that didn't necessarily change the thesis. Medical device technology was still on track to play a big role in the future, and Covidien remained in a perfect position to outperform the market. So despite some concerned voices around him, Bailey stayed with the company. And it did indeed outperform for a number of years – before eventually being bought by Medtronic in 2015.

Learn from your successes and mistakes by adopting a growth mindset.

As a wise man named Kenny Rogers once said, "You gotta know when to hold 'em, and know when to fold 'em." Knowing that holding your stocks can be riddled with behavioral pitfalls and misleading noise is important. But there are also things to be aware of when it comes to knowing when to fold 'em. Let's take a trip in the wayback machine to that first story about General Electric stock. A scenario where a stock was taking a dive – and a lot of people needlessly went down with it. There are many factors that play into why someone might refuse to recognize the writing on the wall, so to speak. One factor is known as the breakeven effect. You may have experienced this yourself if you've spent any time in a casino. It happens when you've been winning for a while. Then, things take a turn – and you're losing money. Still, you keep going, throwing more money into the pot in an effort to just get back to zero. As you can imagine, the breakeven effect has a tendency to simply make a bad situation worse. It's also important to be aware of what's called anchoring. This can happen when you get stuck in an inside view – which is what likely happened to a lot of investors regarding

GE. They were intently listening to the charismatic CEO who presented them with an attractive forecast. He planted the idea of stocks hitting that two-dollar mark, and people anchored themselves to the idea. This made it all the more difficult to switch to an outside view when things got bad; the investors couldn't recognize the situation for what it really was. Another temptation to avoid is the whole "set it and forget it" mindset. As a general rule, you want to focus on a growth mindset, not a fixed mindset. This means recognizing that you can learn from both successes and mistakes and continue to improve day after day, year after year. Following a growth mindset means that you don't want to "set it and forget it." Instead, you want to set up regular intervals where you reevaluate your investment thesis to see if it needs updating or adjusting in order to reflect the outside view. Finally, let's admit it: from time to time, we all make decisions based on negative feelings like regret. If only we'd done this or hadn't done that, we say, things would be different. It's easy to get hung up on this kind of thinking and allow it to muddy our future decision-making. The better path? Pick those regrets apart. Figure out what happened – and learn from the past rather than get hung up on what-ifs. It may sound trite, but it's true: you win some, you lose some. This saying is, in fact, embracing a big-picture outlook. Often, we get so caught up in isolated events that we lose sight of the grand scheme of things: not every pick is going to be a winner, and that's OK as long as you take it into account from the start. To repeat another overused – but nonetheless useful – saying, don't put all your eggs in one basket. Mix it up. Engage in that System 2 thinking. Put together a portfolio that isn't all low-risk or high-risk, that's instead a healthy diversified combination. Above all, keep an open mind, continue to learn along the way, and don't let early missteps scare you off. It might not seem like it at first, but stick with it and you'll see: investing can be fun!

Final summary

The key message in these blinks is that: Within the investment cycle of researching options, picking a stock, analyzing progress, and figuring out when – and when not – to sell, there are a number of behavioral and psychological factors at play. Biases, fears, and influences both internal and external can cause investors to make bad decisions every step of the way. This is the realm of behavioral economics – and recognizing these factors can help you avoid pitfalls, keep a clear head, and make decisions based less on emotions and more on real-world evidence and insights. And here's some more actionable advice: Ask yourself four questions when researching potential stock picks. The behavioral economist and Nobel laureate Richard Thaler came up with four questions to ask yourself when looking at a company. They are, "Who uses? Who chooses? Who pays? Who profits?" In other words, who's using the product or service? Who's choosing which products and services are being offered? Who are the customers or clients paying for these things? And who's profiting – where is that money going? A lot of the time, these answers aren't so clear-cut. But if you ask them regularly and do the hard work of finding answers, you're bound to come away with a much better understanding of how the company operates – and whether it's one you feel confident investing in.