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20 WAYS TO (NOT) MAKE INVESTMENT MISTAKES

Charlie Munger's

crash course in the most frequent misjudgements and how to
avoid them



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Is there an investor who hasn't looked back on his mistakes and said to himself, "I must have been crazy. Why did I do that? Had I gone crazy?" Those investors who haven't said anything like this or never taken a hard look at their own mistakes will probably go on to make more mistakes. All successful investors eventually realise that understanding and controlling their own psychology is at least as important as understanding their investments.



One of the masterpieces of the psychology of why and how people make mistakes is not a dry academic book or article, but a fascinating, witty speech by Warren Buffett's partner and Vice-Chairman of Berkshire Hathaway, Charlie Munger. This speech, 'The psychology of human misjudgement' was given by Munger to the students of his alma mater, Harvard Law School, in 1995.

Munger talked about 25 common misjudgements people make because of the way human psychology operates. Here's an account of 20 of these misjudgements that can have a profound impact on how people invest, or how they don't invest and why they make characteristic mistakes in their investments. We also provide our commentary on how they fit into Indian businesses and Indian investments.



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1

Carrots, sticks and responses

The power that incentives and disincentives hold over our actions



What is it? On a very basic level, it is the tendency to respond to rewards and punishments. Simple as it sounds, Munger cautions that though we tend to think that we recognise the importance of incentives and disincentives in changing

cognition and behaviour, that is often not the case
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“If you would persuade, appeal to interest and not to reason. This maxim is a wise guide to a great and simple precaution in life: Never ever think about something else when you should be thinking about the power of incentives.”

An extreme side of the incentive superpower brings about the ‘incentive-caused bias’, because of which even decent individuals, consciously or unconsciously, fall into immoral behaviour to get what they want by rationalising bad behaviour.

OFTEN FOUND IN: Cases of persuasion and providing incentives

IN LIFE: Money is one of the biggest incentives that drives people’s habits, says Munger. “A rich person will often, through habit, work or connive energetically for more money long after he has almost no real need for more. Money rewards are also intertwined with other forms of reward. For instance, some people use money to buy status and others use status to get money, while still others sort of do both things at the same time.”

There are other rewards that act as incentives: sex, friendship, companionship, advancement in status, and other nonmonetary items. They act in a similar fashion to change or influence behaviour.

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Incentives are a powerful driver of human behaviour. If you want to persuade someone, appeal to his interest, not to reason.

And then there is ‘Granny’s Rule’, which, according to Munger, provides an example of reward superpower that works with astounding success. What is it? “The requirement that children eat their carrots before they get the dessert.” According to Munger, “You can successfully manipulate your own behaviour with this rule, even if you are using as rewards items that you already possess!”

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IN CORPORATIONS: The most important rule in management, according to Munger, is to get the incentives right. That, as he illustrates, FedEx found after trying all tricks in its books.

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In investing, the lesson is that you should fear professional advice when it is especially good for the advisor.

“One of my favorite cases about the power of incentives is the Federal Express case. The integrity of the Federal Express system requires that all packages be shifted rapidly among airplanes in one central airport each night. And the system has no integrity for the customers if the night work shift can’t accomplish its assignment fast. And Federal Express had one hell of a time getting the night shift to do the right thing. They tried everything in the world without luck. And, finally, somebody got the happy thought that it was foolish to pay the night shift by the hour when what the employer wanted was not maximized billable hours of employee service but faultfree, rapid performance of a task. Maybe, this person thought, if they paid the employees per shift and let them go home when all the planes were loaded, the system would work better. And, lo and behold, that solution worked.”

The power of incentives is also most visible in owner-run companies compared to public-sector ones. Whereas owners survive brutal competition by preventing all wasteful operational expenditure, that incentive is often absent in a public-sector unit whose employee functions with the incentive-caused bias to determine “what service he will give in exchange for his salary and how much he will yield to peer pressure from many fellow employees who do not desire his creation of any strong performance model.”

IN INVESTING: The lessons are often direct. Should you trade more on the tips that your stockbroker provides regularly? Do you sell your stock that has made gains only because it has met your broker’s target price? What is your portfolio manager’s incentive behind churning your investments?

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Munger advises how we can arm ourselves. “Widespread incentive-caused bias requires that one should often distrust, or take with a grain of salt, the advice of one’s professional advisor. The general antidotes here are: (1) especially fear professional advice when it is especially good for the advisor; (2) learn and use the basic elements of your advisor’s trade as you deal with your advisor; and (3) double check, disbelieve, or replace much of what you’re told, to the degree that seems appropriate after objective thought.”

2

Like a mother’s love

The power that love holds over individuals



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WHAT IS IT? This is the tendency to love and the actions that this tendency can result in. The most common effect of this tendency is the loss of objectivity

Why is this tendency important to consider? Think of news reports of extreme steps that people take, being in love. The effects of the liking/loving tendency are more profound than they appear. Says Munger, “One very practical consequence of the liking/ loving tendency is that it acts as a conditioning device that makes the liker or lover tend (1) to ignore faults of, and comply with wishes of, the object of his affection, (2) to favor people, products, and actions merely associated with the object of his affection and (3) to distort other facts to facilitate love.”



OFTEN FOUND IN: Individuals



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Companies use the loving tendency to their advantage by increasingly using celebrities to endorse their products.

IN LIFE: The purest form of love is between a mother and her child. A child is born to like and love. The tendency to love is not restricted to blood relations. “Each child, will almost surely come to like and love, not only as driven by its sexual nature, but also in social groups not limited to its genetic or adoptive “family.””

The tendency to love produces another need – to be loved. “And what will a man naturally come to like and love, apart from his parent, spouse and child? Well, he will like and love being liked and loved. And so many a courtship competition will be won by a person displaying exceptional devotion, and man will generally strive, lifelong, for the affection and approval of many people not related to him.”



Due to the loving tendency, many investors fall in ‘love’ with their stocks.

There are positive sides to the liking/ loving tendency. It can positively impact a person’s life if he develops a liking towards an admirable person – a model worthy of emulation. “Liking or loving, intertwined with admiration in a feedback mode, often has vast practical consequences in areas far removed from sexual attachments. For instance, a man who is so constructed that he loves admirable persons and ideas with a special intensity has a huge advantage in life. This blessing came to both Buffett and myself in large measure, sometimes from the same persons and ideas. One common, beneficial example for us both was Warren’s uncle, Fred Buffett, who cheerfully did the endless grocery-store work that Warren and I ended up admiring from a safe distance. Even now, after I have known so many other people, I doubt if it is possible to be a nicer man than Fred Buffett was, and he changed me for the better.”

IN CORPORATIONS: Think how companies use celebrities to induce viewers to develop a liking for their products. The onair promotion by Deepika Padukone of the Tanishq jewellery for her mom has more than 24 lakh hits on YouTube as of

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this writing. What if even a fraction of those viewers decides to visit the nearest Tanishq store?

IN INVESTING: The most straightforward example where this tendency is visible is scores of investors and even fund managers who have gained from learning sound investing principles from Warren Buffett or Charlie Munger. In the absence of that influence, many investors would take other unproductive routes like technicals, short-term trading, chasing market trends, buying hot stocks, etc.

The flip side of this tendency is when an investor develops a possessiveness about a stock that he owns. An investor emotionally attached to his stock may consciously or subconsciously become oblivious of changing realities. Many investors continued to invest in realty stocks even as these companies piled on huge debts to get ahead in the bidding game. Many investors similarly kept on holding on to infrastructure stocks. They were caught between mountain of debts and slowdown in the economy.

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Hate makes us blind, just as love

The wrecking ball that hate can become



What is it? The flip side of the Introduction
liking/loving tendency, this tendency causes us to ignore the virtues of people or things that we hate or dislike and can often lead to distortion of facts to perpetuate that hatred.



The disliking/hating tendency is an ancient behaviour, says Munger. “The long history of man contains almost continuous war. For instance, most American Indian tribes warred incessantly, and some tribes would occasionally bring captives home to women so that all could join in the fun of torturing captives to death. Even with the spread of religion and the advent of advanced civilization, much modern war remains pretty savage.”

Just how strong a hold hatred can take over our lives is visible from the continued grudge a person can hold against another long after he may have forgotten what the original feud was about. This ‘hating-to-the-guts’ tendency is programmed into human behaviour. Munger notes, “The dislikings and hatreds never go away completely. Born into man, these driving tendencies remain strong. Thus, we get maxims like the one from England: ‘Politics is the art of marshalling hatreds’. And we also get the extreme popularity of very negative political advertising in the United States.”

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The hating tendency can make investors hate a company, when it’s perfectly okay.

OFTEN FOUND IN:Nearly everyone



IN LIFE: Who among us has not seen family feuds? Now you can pinpoint the culprit – the disliking/hating tendency. “At the family level, we often see one sibling hate his other siblings and litigate with them endlessly if he can afford it. Indeed, a wag named Buffett has repeatedly explained to me that a major difference between rich and poor people is that the rich people can spend their lives suing their relatives.”

The disliking/hating tendency sneaks up on the hater, who starts behaving in the following manner: “(1) ignore virtues in the object of dislike, (2) dislike people, products, and actions merely associated with the object of his dislike, and (3) distort other facts to facilitate hatred.

Distortion of that kind is often so extreme that miscognition is shockingly large. When the World Trade Center was destroyed, many Pakistanis immediately concluded that the Hindus did it, while many Muslims concluded that the Jews did it. Such factual distortions often make mediation between opponents locked in hatred either difficult or impossible. Mediations between Israelis and Palestinians are difficult because facts in one side’s history overlap very little with facts from the other side’s.”



In a family-run business, a family feud can be a severe drain on investor money.

IN CORPORATIONS: The disliking/ hating tendency can play havoc with investors’ money if the business is family-run and is caught up in a family feud. Consider the cases of BPL, Mafatlal and Bajaj. For an excellent discussion on family feuds wrecking Indian businesses, read the excellent book *Business Battles: Family Feuds That Changed Indian Industry* by Shyamal Majumdar.

IN INVESTING: The disliking/hating tendency interferes with clear thinking. Many investors who bought into the Infosys story at the peak of the technology bull run did not see their investments recover in the six years following the tech crash of 2000. It didn’t matter that they could buy the same stock at 75 per cent discount

from its lifetime peak for many years after the tech meltdown. Anyone who would have invested in the stock as late as 2003 would now be sitting on a 10x multi-bagger.

4

Look before you leap

How quick decisions taken to avoid doubt can backfire



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What is it? Many of us rush to a decision so that any doubts we have about the decision are quickly eliminated. The decision taken under the influence of the doubt-avoidance tendency may not always be rational or objective. Says Munger, “The brain of a man is programmed with a tendency to quickly remove doubt by reaching some decision.”

Like the dislike/hate tendency, Munger views this tendency as an ancient make-up that has been a part of evolution. “It is easy to see how evolution would make animals, over the eons, drift toward such quick elimination of doubt. After all, the one thing that is surely counterproductive for a prey animal that is threatened by a predator is to take a long time in deciding what to do. And so man’s doubt-avoidance tendency is quite consistent with the history of his ancient, nonhuman ancestors.” You could also think of this tendency as a survival tactic.

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The brain of a man is programmed with a tendency to quickly remove doubt by reaching some decision.

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What triggers the doubt-avoidance tendency? “Well, an unthreatened man, thinking of nothing in particular, is not being prompted to remove doubt through rushing to some decision. What usually triggers the doubt-avoidance tendency is some combination of (1) puzzlement and (2) stress. And both of these factors naturally occur in facing religious issues. Thus, the natural state of most men is in some form of religion. And this is what we observe.”

OFTEN FOUND IN: Process of making quick decisions

IN LIFE: Not only ordinary citizens but persons in responsible places like judges and jurors too are susceptible to this tendency. How does one then overcome this tendency? Munger says, “So pronounced is the tendency in a man to quickly remove doubt by reaching some decision that behavior to counter the tendency is required from judges and jurors. Here, delay before decision making is forced. And one is required to so comport himself, prior to conclusion time, so that he is wearing a “mask” of objectivity. And the “mask” works to help real objectivity along.”



The doubt-avoidance tendency causes irrational buying behaviour in a bull run.

IN INVESTING: The doubt-avoidance tendency is most visible usually in the thick of a bull run, when new investors who have been late to the party invest at the drop of a hat, without any research and analysis. Everyone seems to be in a hurry to make gains. The whole country seems to be in the grip of buying on impulse, helped in a large effect by the increased usage of smartphones. Many investors click ‘buy’ on stocks as if they shop for clothes or household items. We need to guard ourselves against such behaviour.



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Shutting out new inputs

How holding onto old ideas in the face of change can harm us

What is it? This is the tendency of humans to be reluctant to change anything that is inconsistent with their prior-held beliefs. Says Munger, “Lord Keynes pointed out, it was not the intrinsic difficulty of new ideas that prevented their acceptance. Instead, the new ideas were not accepted because they were inconsistent with old ideas in place. What Keynes was reporting is that the human mind works a lot like the human egg. When one sperm gets into a human egg, there’s an automatic shut-off device that bars any other sperm from getting in. The human mind tends strongly toward the same sort of result.



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The inconsistency-avoidance tendency leads to resistance to changing our own bad habits in spite of being aware of them.

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And so, people tend to accumulate large mental holdings of fixed conclusions and attitudes that are not often reexamined or changed, even though there is plenty of good evidence that they are wrong.”

This tendency comes in our way of changing bad habits. “Few people can list a lot of bad habits that they have eliminated, and some people cannot identify even one of these. Practically everyone has a great many bad habits he has long maintained despite their being known as bad. Given this situation, it is not too much in many cases to appraise early-formed habits as destiny. When Marley’s miserable ghost says, “I wear the chains I forged in life,” he is talking about chains of habit that were too light to be felt before they became too strong to be broken.”

So strong is the hold of the inconsistency-avoidance tendency that many individuals will not change their ideas, views or habits long after necessary. “It is easy to see that a quickly reached conclusion, triggered by the doubt-avoidance tendency, when combined with a tendency to resist any change in that conclusion, will naturally cause a lot of errors in cognition for the modern man. And so it observably works out. We all deal much with others whom we correctly diagnose as imprisoned in poor conclusions that are maintained by mental habits they formed early and will carry to their graves.”

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To overcome this tendency, search out for views that go against your own, evaluate whether your prior held views still hold ground.

How to protect yourself from this tendency? Search out for views that go against your own, evaluate whether your prior held views still hold ground. This is what Charles Darwin used to weed out inconsistency-avoidance tendency. Says Munger, “One of the most successful users of an antidote to first conclusion bias was Charles Darwin. He trained himself, early, to intensively consider any evidence tending to disconfirm any hypothesis of his, more so if he thought his hypothesis was a particularly good one.”

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OFTEN FOUND IN: Situations where one is confronted with a new reality

IN LIFE: Courts have had to resort to strategies to tackle this tendency. “Before making decisions, judges and juries are required to hear long and skillful presentations of evidence and argument from the side they will not naturally favor, given their ideas in place. And this helps prevent considerable bad thinking from the “first conclusion bias.”

IN CORPORATIONS: Many corporations that are aware of the inconsistency-avoidance tendency form groups to take in counter arguments before taking a decision. Think of test groups that companies employ before taking their products public. Views from such groups are then considered to find out the changes needed before a market launch.

IN INVESTING: There was an old folklore among Indian investors. Investors of our father’s generation used to lap up anything that Dhirubhai Ambani offered. The thinking used to go like this: Invest with Reliance to build wealth for your child’s education or marriage. Any investor buying Reliance with that belief in the last ten years would have seen his investment grow at a CAGR of just 5% per annum.

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Only the curious learn

How the ‘eagerness to learn’ tendency pays off



What is it? This is the tendency to remain curious of one's surroundings. The curiosity tendency is indeed a curious entry in Munger's list of tendencies. You may wonder why. Because it apparently is a positive tendency. Says Munger, "Curiosity, enhanced by the best of modern education (which is by definition a minority part in many places), much helps man to prevent or reduce bad consequences arising from other psychological tendencies."

Do not underestimate the power of curiosity. Many inventions and accidental discoveries have been found to have begun as curiosities. This behaviour is an ancient practice that old civilisations benefitted from. Says Munger, "Athens (including its colony, Alexandria) developed much math and science out of pure curiosity while the Romans made almost no contribution to either math or science. They instead concentrated their attention on the "practical" engineering of mines, roads, aqueducts, etc."

OFTEN FOUND IN: Sources of learning, inventions and discoveries

IN LIFE: Curiosity is often the basis of learning. And with continuous learning comes great payoffs. Says Munger, "The curious are also provided with much fun and wisdom once formal education has ended."



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A curious mind goes a long way in ensuring investing success as it leads to better research and thorough analysis.

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IN CORPORATIONS: ^{Introduction} The lack of curiosity in corporations can result in disastrous results. Companies need to keep an open mind about how changes in environment could affect operations.

IN INVESTING: Rather than looking out for the next hot stock, researching a stock with a curious mind is likely to produce better results. You won't be vulnerable to any bad tips or stocks that your broker tells you.

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The instinct for fairness

How the “Do unto others as you would have done unto you” philosophy works in our lives

What is it? This tendency refers to our inclination to be treated fairly and the problems that not being treated fairly can cause. When people expect fair behaviour but do not get it, that gives rise to hostility.

The tendency comes from Immanuel Kant, a German philosopher of the 1700s. Munger says, “Kant was famous for his “categorical imperative,” a sort of “golden rule” that required humans to follow those behaviour patterns that, if followed by all others, would make the surrounding human system work best for everybody. And it is not too much to say that modern acculturated man displays, and expects from others, a lot of fairness as thus defined by Kant.” ↑

FOUND IN: Expectations of fairness

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IN LIFE: The Kantian behaviour can be found in even mundane acts, says Munger. “In a small community having a one-way bridge or tunnel for autos, it is the norm in the United States to see a lot of reciprocal courtesy, despite the absence of signs or signals. And many freeway drivers, including myself, will often let other drivers come in front of them, in lane changes or the like, because that is the courtesy they desire when roles are reversed. Moreover, there is, in modern human culture, a lot of courteous lining up by strangers so that all are served on a “first-come-first-served” basis.”

IN INVESTING: Kantian tendency comes into play in investing when companies act against minority shareholders. A number of foreign MNCs operating in India have indulged in practices not in the interests of minority shareholders. Some of the methods include: paying a higher royalty to foreign parent company as HUL did, even in the face of falling volume growth or merging of an unlisted subsidiary at high valuations (Akzo Nobel) or transfer of profitable division to the parent company at lower valuations (Siemens) or transfer of core business to an unlisted subsidiary of the parent (Maruti).



This behaviour becomes a problem for investors when companies decide to take such actions with disregard towards minority shareholders. Such companies should better be avoided.



The telltale sign of a good management is how it treats the minority shareholders in the company.



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The green goddess strikes

How envy and jealousy affect us



What is it? We often tend to underestimate the effects of envy and jealousy but seldom do we understand the effects they have in our lives. Envy and jealousy are a part of our evolutionary make-up, says Munger. “A member of a

species designed through evolutionary process to want often-scarce food is going to be driven strongly toward getting food when it first sees food. And this is going to occur often and tend to create some conflict when the food is seen in the possession of another member of the same species. This is probably the evolutionary origin of the envy/jealousy tendency that lies so deep in the human nature.”

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Envy and jealousy are a part of our evolutionary make-up. However, they are highly unproductive and a serious flaw of the human nature.

The vices of jealousy have been warned about in the scriptures of every religion. “Envy/jealousy is extreme in myth, religion, and literature, wherein, in account after account, it triggers hatred and injury. It was regarded as so pernicious by the Jews of the civilization that preceded Christ that it was forbidden, by phrase after phrase, in the laws of Moses. You were even warned by the Prophet not to covet your neighbor’s donkey,” says Munger.

OFTEN FOUND IN: The ‘have-nots’!

IN LIFE: How about one of the most common example of a friend or a colleague or that snob relative who is making more money than you and flashing it all around. Munger has some words of advice, “The idea of caring that someone is making money faster [than you are] is one of the deadly sins. Envy is a really stupid sin because it’s the only one you could never possibly have any fun at. There’s a lot of pain and no fun. Why would you want to get on that trolley?”

Want more? “Well envy/jealousy made, what, two out of the ten commandments? Those of you who have raised siblings you know about envy, or tried to run a law firm or investment bank or even a faculty? I’ve heard Warren say a half a dozen times, ‘It’s not greed that drives the world, but envy.’

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If you're comfortably rich and someone else is getting richer faster than you, so what? Someone will always be getting richer faster than you.

IN CORPORATIONS: “Many big law firms, fearing disorder from envy/jealousy, have long treated all senior partners alike in compensation, no matter how different their contributions to firm welfare.”

IN INVESTING: How about some wisdom from Munger? Munger says, “Missing out on some opportunity never bothers us. What’s wrong with someone getting a little richer than you? It’s crazy to worry about this.”

“Here’s one truth that perhaps your typical investment counselor would disagree with: if you’re comfortably rich and someone else is getting richer faster than you by, for example, investing in risky stocks, so what?! Someone will always be getting richer faster than you. This is not a tragedy.” It’s as simple as this.

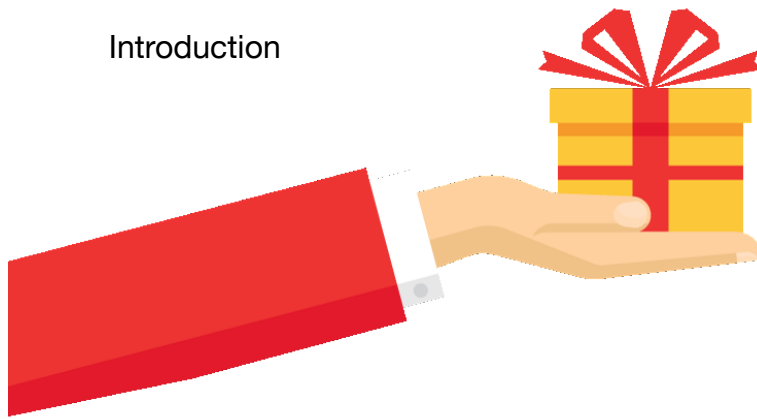
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Return gifts

How far the ‘give and take’ policy goes in life and in relationships



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What is it? This is the tendency of humans to reciprocate both favours and disfavours. The reciprocation tendency has two sides: the bright side, where it brings people to cooperate together for their common benefit, and the dark side, because of which it has been the cause of wars, extreme

hatred and injury. Says Munger, “For long stretches in many wars, no prisoners were taken; the only acceptable enemy being a dead one. And sometimes that was not enough, as in the case of Genghis Khan, who was not satisfied with corpses. He insisted on their being hacked into pieces.”

Let’s not forget that the reciprocation tendency also has a beautiful side - that of returning a favour with a favour. Munger gives a touching example of the reciprocation tendency in action, “Of course, the tendency to reciprocate favor for favor is also very intense, so much so that it occasionally reverses the course of reciprocated hostility. Weird pauses in fighting have sometimes occurred right in the middle of wars, triggered by some minor courtesy or favor on the part of one side, followed by favor reciprocation from the other side, and so on, until fighting stopped for a considerable period. This happened more than once in the trench warfare of World War I, over big stretches of the front and much to the dismay of the generals.”

The reciprocation tendency, like other tendencies, is susceptible to abuse by conniving individuals. Such people make small concessions that tend to be reciprocated from the opposite side with a concession that is often larger than the original concession tendered. Charlie Munger puts it well, “The tendency (is) a strong force that can sometimes be used by some men to mislead others, which happens all the time. For instance, when an automobile salesman graciously steers you into a comfortable place to sit and gives you a cup of coffee, you are very likely being tricked, by this small courtesy alone, into parting with an extra five hundred dollars.”





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Many companies shower analysts covering them with expensive gifts in their analyst meets, expecting them to write favourably about them.

OFTEN FOUND IN: Relationships, warring parties

IN LIFE: Here's something that many of us indulge in. "The reciprocity-based, religion-boosting idea of obtaining help from God in reciprocation for good human behavior has probably been vastly constructive."

The reciprocation tendency plays a very important role in our lives: forming the basis of human relationships. Says Munger, "The very best part of human life probably lies in relationships of affection wherein parties are more interested in pleasing than being pleased – a not uncommon outcome in display of reciprocate-favor tendency." There needn't be war for the dark side of the reciprocation tendency to exhibit itself. "Peacetime hostility can be pretty extreme, as in many modern cases of "road rage" or injury-producing temper tantrums on athletic fields.

The standard antidote to one's overactive hostility is to train oneself to defer reaction. As my smart friend Tom Murphy so frequently says, 'You can always tell the man off tomorrow if it is such a good idea', says Munger

The reciprocation tendency also works in marriages. "Daily interchange in marriage is also assisted by the reciprocation tendency, without which marriage would lose much of its allure."

IN CORPORATIONS: The reciprocation tendency is all too common in the corporate world. One vendor, for instance, can do a favour to a purchasing manager and can get favours in return. Many contracts are sealed through the process of reciprocation – "you do this and I'll give the order to you."

Munger points how corporations tend to nullify the effects of reciprocation tendency. He says, "Wise employers, therefore, try to oppose reciprocate-favor↑ tendencies of employees engaged in purchasing. The simplest antidote works best:

Don't let them accept any favors from vendors. Sam Walton agreed with this idea of absolute prohibition. He wouldn't let purchasing agents accept so much as a hot dog from a vendor. Given the subconscious level at which much reciprocation tendency operates, this policy of Walton's was profoundly correct."

IN INVESTING: Did you know that many companies shower analysts covering them with expensive gifts in their analyst meets? The reciprocation tendency at play here expects that the analysts taking home these gifts would write favourably about them.

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Misleading associations

How the tendency to make decisions based on associations can mislead us

What is it? This is the tendency of humans to be misled because of prior associations. This behaviour, says Munger, is a "responsive behavior, creating a new habit, is directly triggered by rewards previously bestowed." Take the example of a man buying a branded shoe polish. He has a good experience with it, and because of this experience he buys the same shoe polish when he needs another.



A common form of influence from association comes from something we are well aware of. This is called blanket stereotyping. For example, if someone is a Punjabi, we assume that he will be a hearty eater; if a Bengali, he should be cultured in the arts; if a South Indian, he must be brainy; if an Indian, he must be argumentative in nature. Then there is another type of association – that of a news messenger and the bad news he delivers. “Another common bad effect of the mere association of a person and a hated outcome is displayed in the “Persian messenger syndrome.” Ancient Persians actually killed some messengers whose sole fault was that they brought home truthful bad news, say, of a battle lost. It was actually safer for the messenger to run away and hide, instead of doing his job as a wiser boss would have wanted it done.”



Munger’s prescription to avoid the mere-association tendency is pure genius. “To avoid being misled by the mere association of some fact with past success, use this memory clue. Think of Napoleon and Hitler when they invaded Russia after using their armies with much success elsewhere.”

He further elaborates, “The proper antidotes to being made such a patsy by past success are (1) to carefully examine each past success, looking for accidental, non-causative factors associated with such success that will tend to mislead as one appraises odds implicit in a proposed new undertaking and (2) to look for dangerous aspects of the new undertaking that were not present when past success occurred.”

OFTEN FOUND IN: Classifying products, brands or persons

IN LIFE: Take the association with price, for example. What do we normally tend to think about a product if it is priced higher? We think that it offers better quality. Munger warns against this. “Knowing this, some seller of an ordinary industrial product will often change his product’s trade dress and raise its price significantly,

hoping that quality-seeking buyers will be tricked into becoming purchasers by mere association of his product and its high price. This industrial practice frequently is effective in driving up sales and even more so in driving up profits... With luxury goods, the process works with a special boost because buyers who pay high prices often gain extra status from thus demonstrating both their good taste and their ability to pay.”

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Stereotyping leads to irrational prejudices. A prejudiced person tends to overgeneralise and overlook the differences in what he is biased against.

Love causes a powerful influence from mere-association tendency. People tend to get blind in love. Often mothers of convicted killers grieve with conviction about the innocence of their sons. Says Munger, “People disagree about how much blindness should accompany the association called love. In Poor Richard’s Almanack, Franklin counseled: ‘Keep your eyes wide open before marriage and half shut thereafter’. Perhaps this “eyes-half-shut” solution is about right, but I favor a tougher prescription: See it like it is and love anyway.”

IN CORPORATIONS: Corporations extensively employ this tendency. Says Munger, “Advertisers know about the power of mere association. You won’t see Coke advertise alongside some account of the death of a child. Instead, Coke ads picture life as happier than reality.” Many aspiring brands utilise star power to sell their products.

Munger cites how the Persian messenger syndrome also affects corporations to cause huge losses. “CBS, in its late heyday, was famous for occurrence of the Persian messenger syndrome because Chairman Paley was hostile to people who brought him bad news. The result was that Paley lived in a cocoon of unreality, from which he made one bad deal after another, even exchanging a large share of CBS for a company that had to be liquidated shortly thereafter.”

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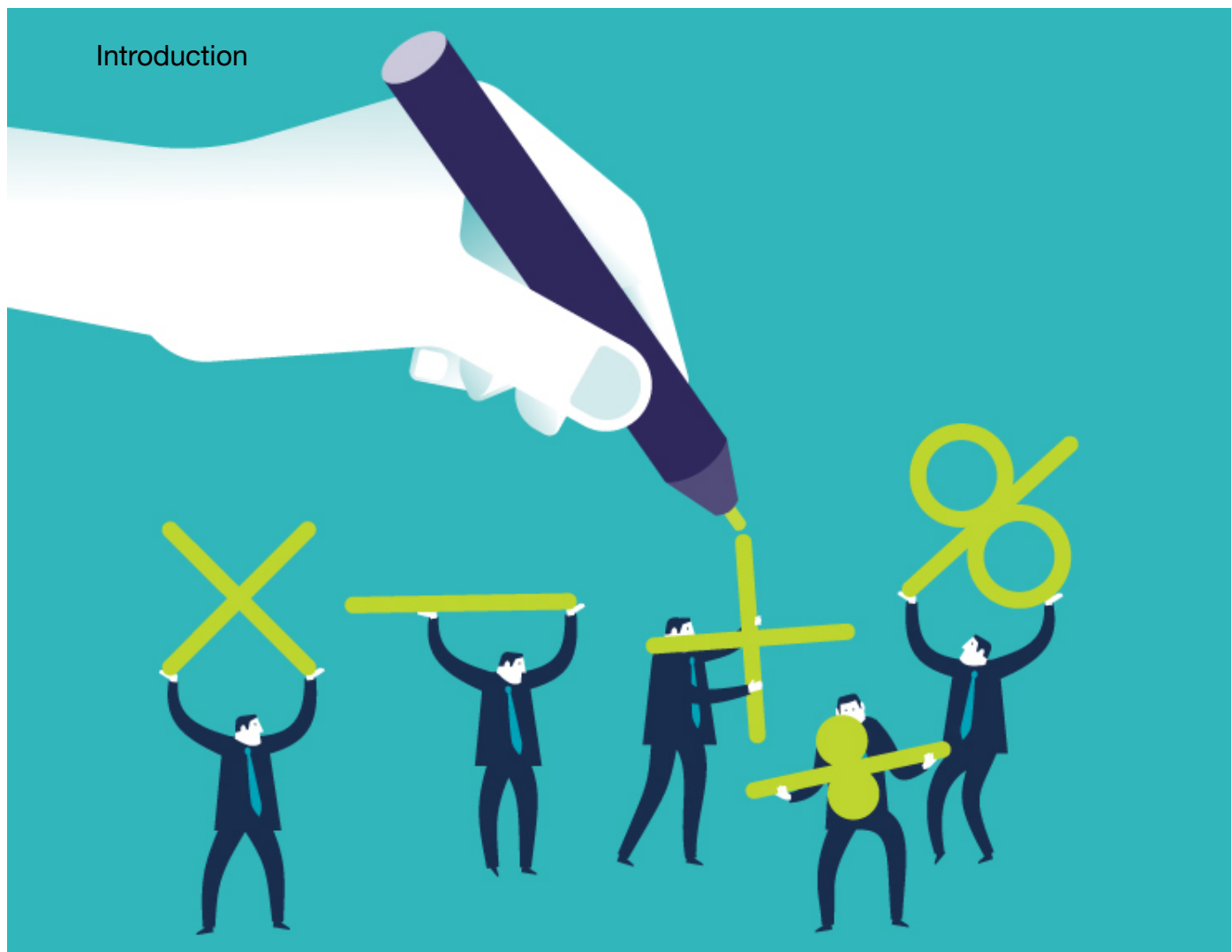
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“The proper antidote to the Persian messenger syndrome and its bad effects is to develop, through exercise of will, a habit of welcoming bad news. At Berkshire, there is a common injunction: Always tell us the bad news promptly. It is only the good news that can wait.”

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OVERRATING ONESSELF

How the tendency to overrate ONE'S abilities, possessions and decisions can hurt





What is it? This is the tendency of humans to overrate their decisions, possessions as well as abilities. Munger gives the example of Swedish divers, 90 percent of whom judge themselves to be above average. This however cannot be true in real life.

This tendency also appears in the case of possessions. Says Munger, “Even man’s minor possessions tend to be overappraised. Once owned, they suddenly become worth more to him than he would pay if they were offered for sale to him and he didn’t already own them. There is a name in psychology for this overappraise-your-own-possession phenomenon: the “endowment effect.””

The Russian novelist and author of War and Peace (1869) once wrote of the power of excessive self-regard tendency. Munger says, “According to Tolstoy, the worst criminals don’t appraise themselves as all that bad. They come to believe either (1)

that they didn't commit their crimes or (2) that, considering the pressures and disadvantages of their lives, it is understandable and forgivable that they behaved as they did and became what they became.”

Introduction

Excessive self-regard is not all bad. It does have some positive benefits too. Munger says, “While an excess of self-regard is often counterproductive in its effects on cognition, it can cause some weird successes from overconfidence that happens to cause success. This factor accounts for the adage: “Never underestimate the man who overestimates himself.”

Of course, some high self-appraisals are correct and serve better than false modesty. Moreover, self-regard in the form of a justified pride in a job well done, or a life well lived, is a large constructive force. Without such justified pride, many more airplanes would crash.”

OFTEN FOUND IN: Assessment of one's own abilities, decisions, etc.

IN LIFE: How many times you have heard parents go overboard praising their bright kids? Munger explains some of the worst incidences of the excessive self-regard tendency come into life when “dysfunctional groups of cliquish persons, dominated by excessive self-regard tendency, select as new members of their organizations persons who are very much like themselves. Thus if the English department at an elite university becomes mentally dysfunctional or the sales department of a brokerage firm slips into routine fraud, the problem will have a natural tendency to get worse and to be quite resistant to change for the better.”

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A sustained bull run may induce an investor to think of himself as exceptional, though the actual reason may simply be the markets going up.

But there is an antidote for falling into the excessive self-regard tendency. According to Munger, “The best antidote to folly from an excess of self-regard is to force yourself to be more objective when you are thinking about yourself, your

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family and friends, your property, and the value of your past and future activity. This isn't easy to do well and won't work perfectly, but it will work much better than simply letting psychological nature take its normal course."

Introduction

IN INVESTING: Sometimes after a good run in a bull market, we get lulled into believing that we are very good at the investing game, even though one of the primary reasons for the good run could be the general market going up. Says Munger, "Intensify man's love of his own conclusions by adding the possessory wallop from the "endowment effect," and you will find that a man who has already bought a pork-belly future on a commodity exchange now foolishly believes, even more strongly than before, in the merits of his speculative bet."

12

The optimist's folly

How the human tendency to remain over-optimistic can affect decisions

WHAT IS IT? This is our natural tendency to be over-optimistic and how that affects our decisions. Take a common example you may have heard a number of times. The ancient Greek orator Demosthenes famously said three centuries before Christ, "What a man wishes, that also will he believe."



What is the antidote to the overoptimism tendency? Here is Munger's prescription, "One standard antidote to foolish optimism is trained, habitual use of the simple probability math of Fermat and Pascal, taught in my youth to high school sophomores."

OFTEN FOUND IN: Our views about things that affect us

IN LIFE: It is not necessary for us to suffer or be in pain for the overoptimism tendency to come into action.

As humans, we often display an excess of self-optimism even where there is no pain or threat of pain. As such, excessive self-optimism tendency becomes a normal human condition that can lead us to believing a number things that may not be correct. Munger gives the example of "happy people buying lottery tickets or believing that credit-furnishing, delivery-making grocery stores were going to displace a great many superefficient cash-and-carry supermarkets."



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Over-optimism can induce us to take more risk than what we can handle.

IN CORPORATIONS: Even companies can get carried away with the overoptimism bug. Tulsi Tanti of Suzlon went on a global shopping spree apparently overoptimistic about the wonders that wind power could do for him. Tata acquired Corus just before the financial crisis hit and was saddled with debt. Havells acquired Sylvania – a company much bigger than itself – and nearly went down under

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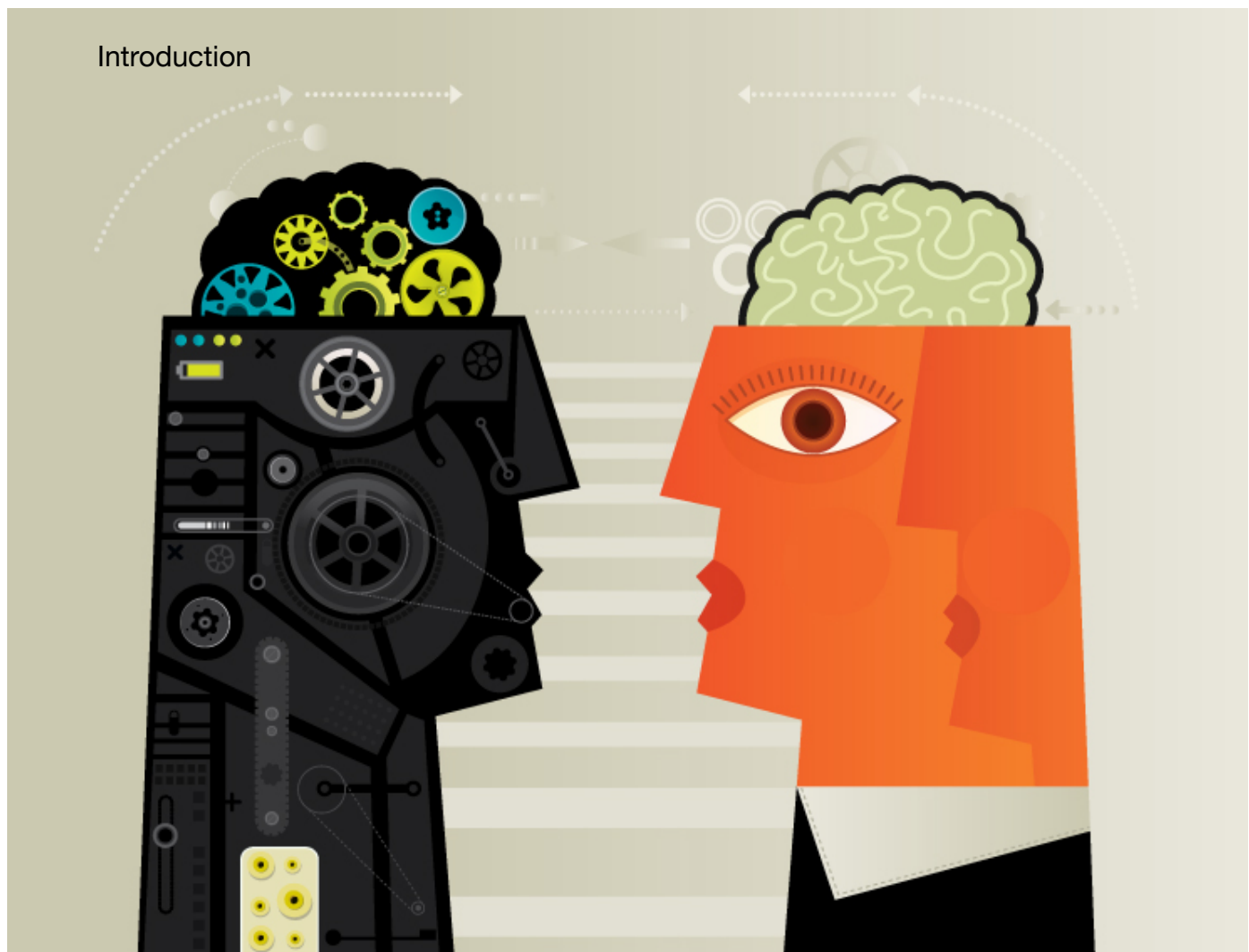
IN INVESTING: The overoptimism bug in investing can cause much harm if you continue to remain over-optimistic about a company, trend or market direction.

13

Mourning over trivialities

How a loss or a threatened loss can lead us to overreact – often to our own detriment





WHAT IS IT? This is the human tendency to hugely overreact to a loss or a threatened loss of a loved one, property, friendship, one's territory, status, etc.

The crux of this tendency is misframing of the problem, says Munger. “In displaying the deprivation-superreaction tendency, man frequently incurs disadvantage by misframing his problems. He will often compare what is near instead of what really matters. For instance, a man with \$10 million in his brokerage account will often be extremely irritated by the accidental loss of \$100 out of the \$300 in his wallet.”

OFTEN FOUND IN: Auctions, bureaucratic infighting, slot machine players, labour resistance



IN LIFE: Sometimes even neighbours fight over what they perceive as deprivation. One neighbour puts up a large overhead tank that could take up all the water available to other neighbours. Says Munger, “Even a one-degree loss from a 180-degree view will sometime create enough deprivation-superreaction tendency to turn a neighbor into an enemy, as I once observed when I bought a house from one of two neighbours locked into hatred by a tiny tree newly installed by one of them.”

The compulsion to gamble is a wellknown behaviour that has caused financial ruin to many. Now you know it is the deprivation-superreaction tendency to blame. “The deprivation-superreaction tendency is also a huge contributor to ruin from compulsion to gamble. First, it causes the gambler to have a passion to get even once he has suffered loss, and the passion grows with the loss. Second, the most addictive forms of gambling provide a lot of near misses and each one triggers the deprivation-superreaction tendency.”

IN CORPORATIONS: The most visible form of superreaction in corporations has been in the instances of trade union disagreements. Many industries have closed down because of inflexible trade unions that sought to extract the maximum benefits for the labour force. Says Munger, “The deprivation-superreaction tendency has ghastly effects in labor relations. Nowadays, we see more occasions when whole companies disappear, as competition requires either takeaways from labor – which it will not consent to – or death of the business. The deprivation-superreaction tendency causes much of this labor resistance, often in cases where it would be in labor’s interest to make a different decision.”



Deprivation superreaction leads investors to hold onto their multi-baggers forever in the hope of making more profits.

Another form of the deprivation-superreaction tendency is seen in business failures. “The deprivation-superreaction tendency and the inconsistency-avoidance tendency often join to cause one form of business failure. In this form of ruin, a man gradually uses up all his good assets in a fruitless attempt to rescue a big venture from going bad.”

IN INVESTING: ^{Introduction} It is not uncommon to find an investor who doesn't book profits in a stock that turns into a multi-bagger in a very short time. The reasoning goes that it could go higher. However, as innumerable stocks have shown, many gains have been nearly completely reversed in the cases where a stock catches the fancy of the stock market and is later dumped. Says Munger of this behaviour, "Many Berkshire Hathaway shareholders I know never sell or give away a single share after immense gains in market value have occurred. I believe the single strongest irrational explanation is a form of the deprivation-superreaction tendency. Many of these shareholders simply can't stand the idea of having their Berkshire Hathaway holdings smaller. Partly they dislike facing what they consider an impairment of identity, but mostly they fear missing out on future gains from stock sold or given away."

The auction system works in a similar way to create a deprivation-superreaction behaviour. "What if I lose that item? What if it goes to someone else?" Says Munger, "Deprivation-superreaction tendency often does much damage to a man in open-outcry auctions. The "social proof" that we will next consider tends to convince man that the last price from another bidder was reasonable, and then the deprivation-superreaction tendency prompts him strongly to top the last bid. The best antidote to being thus triggered into paying foolish prices at open-outcry auctions is the simple Buffett practice: Don't go to such auctions."

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Herds of dumb sheep ↑

How the 'do-as-others-do' tendency can get the better of us

Introduction



WHAT IS IT? Remember the old saying, “When in Rome, do as the Romans do.” The social proof tendency is the automatic tendency of humans to think or act as those around them. Says Munger, “Monkey see, monkey do is the old phrase that reminds one of how strongly John will often wish to do something, or have something, just because Joe does or has it.”

This tendency does have its advantages. If you’re new in a city, say, Mumbai and don’t know the way around to the stations – the lifeline of the city – then you just need to follow the flow of the crowd. If the crowd is swelling up, you are most likely on the right track to the station.

It is important to keep our minds open when situations that can cause this tendency arise before us. Says Charlie Munger, “When will the social-proof tendency be most easily triggered? Here the answer is clear from many experiments: Triggering most readily occurs in the presence of puzzlement or ↑ stress, and particularly when both exist.”



Introduction

The social-proof tendency is as much about inaction as it is about doing what others are doing. Inaction is in itself a form of action.

Following the actions of others is not the only cause of this tendency. Rather, inaction, is in itself an action. It signals to the brain that inaction on the part of others is the right course of action.

OFTEN FOUND IN: Looking at what others are doing and doing the same thing

IN LIFE: Want some excellent parenting advice you don't see in papers everyday? Listen to Munger, "Teenagers' parents usually learn more than they would like about teenagers' cognitive errors from the social-proof tendency. This phenomenon was recently involved in a breakthrough by Judith Rich Harris, who demonstrated that superrespect by young people for their peers, rather than for parents or other adults, is ordained to some considerable extent by the genes of the young people. This makes it wise for parents to rely more on manipulating the quality of the peers than on exhortations to their own offspring."

IN CORPORATIONS: The social- proof tendency is common in corporations too. Less than two months before the financial crisis of 2008, there was a mad rush to grab real estate in the suburbs of Mumbai. One particular plot of 178 acres belonging to PAL-Peugeot in the Kalyan-Dombivili area saw 35 bidders that counted the who's who of real estate industry, including players like DLF, Indiabulls, Unitech, Omaxe, Akruti Nirman and the Hiranandani group.

The role of outside directors is often debated in the media. It's not without cause. Outside directors are a checking mechanism in the boardroom. What happens in reality though is far from it. Recall that Satyam Computers had many prominent members of society on its board of directors at various times, yet none had any idea of what was really going on in the company. Putting in Charlie Munger's words, "The outside directors on a corporate board usually display the near ultimate form of inaction. They fail to object to anything much short of an axe ↑ murder until some public embarrassment of the board finally causes their

intervention. A typical board-of-directors' culture was once well described by my friend, Joe Rosenfield, as he said, 'They asked me if I wanted to become a director of Northwest Bell, and it was the last thing they ever asked me'."

Introduction

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An investor should not blindly ape another iconic investor with his stock-buying decisions. You never know when the iconic investor may sell out.

IN INVESTING: Many investors try to follow in the footsteps of famed investors – buying what they buy and selling what they sell. The problem with such a practice is (1) you do not know the investment rationale or horizon of the famed investor, and (2) you may be caught unaware if that famed investor makes a quiet exit from the stock.

Here's a piece of advice from Munger. "If only one lesson is to be chosen from a package of lessons involving the social-proof tendency, and used in self-improvement, my favorite would be: Learn how to ignore the examples from others when they are wrong, because few skills are more worth having."

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Faulty comparisons

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How making bad comparisons inevitably leads to bad results

Introduction



WHAT IS IT? This is the tendency of humans to make bad decisions based on faulty comparisons. A husband who marries for the second time will often compare his new wife with his first wife. That comparison is incorrect, and any decisions based on it could have disastrous results on his existing marriage.

OFTEN FOUND IN: Decisions based on two or more alternatives

IN LIFE: Munger explains how real estate agents misuse this tendency. “A particularly reprehensible form of sales practice occurs in the offices of some real estate brokers. A buyer from out of the city, perhaps needing to shift his family there, visits the office with little time available. The salesman deliberately shows the customer three awful houses at ridiculously high prices. Then he shows him a merely bad house at a price only moderately too high. And, boom, the broker often makes an easy sale.”



IN CORPORATIONS: ^{Introduction} The contrast- misreaction tendency is used by conniving corporations to make the illusion that products on offer give a good deal to the customer. This is, however, far from the truth. In a very recent example, Flipkart, one of the country's leading online retailers was found to quote an inflated MRP of ₹799 for a pair of wedges (sandals). The retailer subsequently offered a 50 per cent discount, pricing the sandal at ₹399. A close inspection of the photo reveals that the sandal has a printed MRP of ₹399, making the effective discount zero. But unsuspecting customers could get away thinking that they got a good deal.

IN INVESTING: If a stock is down 50 per cent from its 52-week high, does that make it an attractive buy? Not necessarily. Price comparisons based on past performance are not the correct measure of attractiveness or otherwise of a stock you are looking at. One should look at the current scenario and try to draw future prospects therefrom.

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Destroyed by stress

The impact that stress can have on normal thinking





WHAT IS IT? This is the tendency where an adrenaline rush produces a quicker and more extreme reaction. Less stress can improve performance but heavy stress often leads to dysfunction.

Heavy stress can take a toll on anyone's correct frame of mind. Says Munger, "Few people know more about really heavy stress than that it can cause depression. For instance, most people know that an "acute stress depression" makes thinking dysfunctional because it causes an extreme of pessimism, often extended in length and usually accompanied by activity-stopping fatigue. Fortunately, as most people also know, such a depression is one of mankind's more reversible ailments. Even before modern drugs were available, many people afflicted by depression, such as Winston Churchill and Samuel Johnson, gained great achievement in life." ↑

OFTEN FOUND IN: Instances of heavy stress when the mind ceases to work normally.
Introduction

The Russian scientist Pavlov spent the last years of his life studying stress and its working on dogs that were previously conditioned to different responses. Pavlov's work is an eye-opener on how stress works its way. Munger says, "What happened to cause Pavlov's last work was especially interesting. During the great Leningrad Flood of the 1920s, Pavlov had many dogs in cages. Their habits had been transformed by a combination of his "Pavlovian conditioning" plus standard reward responses into distinct and different patterns. As the waters of the flood came up and receded, many dogs reached a point where they had almost no airspace between their noses and the tops of their cages. This subjected them to maximum stress. Immediately thereafter, Pavlov noticed that many of the dogs were no longer behaving as they had. The dog that formerly had liked his trainer now disliked him, for example. This result reminds one of modern cognition reversals in which a person's love of his parents suddenly becomes hate, as new love has been shifted suddenly to a cult. The unanticipated, extreme changes in Pavlov's dogs would have driven any good experimental scientist into a near-frenzy of curiosity. That was indeed Pavlov's reaction. But not many scientists would have done what Pavlov next did. And that was to spend the rest of his long life giving stress-induced nervous breakdowns to dogs, after which he would try to reverse the breakdowns, all the while keeping careful experimental records. He found (1) that he could classify dogs so as to predict how easily a particular dog would breakdown; (2) that the dogs hardest to breakdown were also the hardest to return to their pre-breakdown state; (3) that any dog could be broken down; and (4) that he couldn't reverse a breakdown except by reimposing stress."

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Investing under stress of outperforming, say the markets or a competitor, opens the field up for mistakes.

IN INVESTING: It is obvious that investing under stress of outperforming, say the markets or a competitor, opens the field up for mistakes. Even the stress of maintaining past performance for fund managers can take its toll and hamper ↑

judgement. The stress of recovering a loss made in one stock to find another that
Introduction
can more than compensate can similarly affect judgement.

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The availability problem

the brain's tendency to grab the most readily available option may not be the best decision

WHAT IS IT? This is the tendency of the human brain to overweigh conveniently available information. Munger warns against the folly of this tendency. He says, "An idea or a feat is not worth more merely because it is easily available to you."

Munger gives a beautiful example of the availability-misweighing tendency with a Frank Sinatra song that goes, "When I'm not near the girl I love, I love the girl I'm near."





Introduction

Man's imperfect, limited-capacity brain easily drifts into working with what's easily available to it.

Availability plays an important role in the functioning of the brain. "Man's imperfect, limited-capacity brain easily drifts into working with what's easily available to it. And the brain can't use what it can't remember or what it is blocked from recognizing because it is heavily influenced by one or more psychological tendencies bearing strongly on it, as the fellow is influenced by the nearby girl in the song. And so the mind overweighs what is easily available and thus displays the availability-misweighing tendency."

How do you stay away from the availability-misweighing tendency? Munger recommends using checklists, which, he says, he has found helpful. A second antidote is to behave like Darwin and search out for disconfirming evidence. Yet another is to search for people who are sceptical of incumbent notions. They can help you.



This tendency can lead an investor to bet on a company simply because it performed well in the last quarter.

OFTEN FOUND IN: Instances where the brain picks the option most readily available to it

IN CORPORATIONS: Availability works wonders for corporations which have their products most closely available to prospective customers. That is how global cola majors Coca-Cola and Pepsi play their game – being the most readily available option. Charlie Munger says, "Ask the Coca-Cola Company, which has raised availability to a secular religion, if availability changes behavior. You will drink a helluva lot more Coke if it's always available. I mean availability does change behavior and cognition."



IN INVESTING: ^{Introduction} This tendency provides fuel to 24-hour business channels, which analyse threadbare how a particular quarter's performance can make or break a company. What the reporters do here is use the most readily available information and try to extrapolate it into the future. So, a company that has performed well gets a pat on the back and is often hardsold, whereas one that may have seen a dip in the most recent performance is torn to bits.

Take Sun Pharma for instance. The once-darling of Indian pharma sector now finds itself a pariah. The pharma major's Halol facility has been under the USFDA scanner since December 2015. One year later, on an inspection by the US agency aimed at resolving all outstanding issues, the USFDA found further observations (observations are made by the USFDA when it finds practices or conditions in a particular facility not conforming to set standards). These new observations now threaten to further delay any resolution for Halol.

Research agency Credit Suisse cut its FY18 earning per share estimate by six per cent following the observation.

The stock, already battered by negative sentiment through all of 2016 operating in a sector struggling with a hawkish USFDA and ongoing pricefixing allegations, is down by 14 per cent – double of what the delay could impact. With major research agencies all calling for an earnings cut and stock downgrade, investment sentiment is turning against Sun Pharma. Amidst negative news and sentiments from all quarters -print media, research agencies and television news channels, the company is fast losing its attractiveness amongst investors – even if the market reaction exceeds the expected impact.



18

The boss is not always right

Why 'follow-the-leader' can have disastrous results



WHAT IS IT? This is the human tendency to follow orders blindly from an authority, even in the cases when the authority could be wrong.

A wrong authority figure, if followed, can cause untold misery. That's what happened when Hitler took over Germany. Many officers that were tried postwar claimed immunity because they were only following orders. Of course, that didn't convince the judges and most of the convicted offenders were executed.





Introduction

Human society is formally organized into dominance hierarchies, augmenting the natural follow-the-leader tendency.

Why are we so susceptible to following orders? It has to do with our culture and the way humans has formed societies. “Living in dominance hierarchies as he does, like all his ancestors before him, man was born mostly to follow leaders, with only a few people doing the leading. And so, human society is formally organized into dominance hierarchies, with their culture augmenting the natural follow-the-leader tendency of man.”

OFTEN FOUND IN: Instances of subordination

American social psychologist Stanley Milgram conducted the now famous Milgram experiments that demonstrated the power of the authority-misinfluence tendency. Says Munger, “One clever psychology professor, Stanley Milgram, decided to do an experiment to determine exactly how far authority figures could lead ordinary people into gross misbehavior. In this experiment, a man posing as an authority figure, namely a professor governing a respect able experiment, was able to trick a great many ordinary people into giving what they had every reason to believe were massive electric shocks that inflicted heavy torture on innocent fellow citizens. This experiment did demonstrate a terrible result contributed to by the authority-misinfluence tendency.”



Many corporations suffer when the top boss may be completely wrong but his subordinates fear telling him about his mistakes.

IN CORPORATIONS: Many corporations suffer from this tendency when the top boss may be completely wrong but his subordinates fear telling him about his mistakes. Says Munger, “So strong is undue respect for authority that this CEO, and many even worse examples, have actually been allowed to remain in control of important business institutions for long periods after it was clear they should be

removed. The obvious implication: Be careful whom you appoint to power because a dominant authority figure will often be hard to remove, aided as he will be by the authority-misinfluence tendency.”

Introduction

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Waste not, want not

How meaningless activities affect you and others

WHAT IS IT? The dictionary definition of ‘twaddle’ is silly idle talk, something that is insignificant or worthless. Humans have a tendency to engage in twaddle or meaningless activities that don’t amount to much.

OFTEN FOUND IN: Any activity that is not meaningfully significant or which doesn’t make sense



IN LIFE: The twaddle tendency, if left unchecked, can result in a lot of lost time or resources. How to separate twaddle from meaningful work? Munger says, “A rightly famous Caltech engineering professor, exhibiting more insight than tact,



once expressed his version of this idea as follows: ‘The principal job of an academic administration is to keep the people who don’t matter from interfering with the work of the people that do’.”

Introduction

IN INVESTING: Twaddle shows its head in investing too. Think of the hundreds of TV experts dishing out sermons on stocks and markets every day.

Another example is of fund managers. A favourite strategy of fund houses is to package funds into value or growth and then sell them separately to investors who are interested in either.

According to Munger, “The whole concept of dividing it up into ‘value’ and ‘growth’ strikes me as twaddle. It’s convenient for a bunch of pension fund consultants to get fees prattling about and a way for one adviser to distinguish himself from another. But, to me, all intelligent investing is value investing – acquiring more than you are paying for. You must value the business in order to value the stock.” This solves the problem for many of us who are concerned about value and growth.

20

The lollapalooza effect

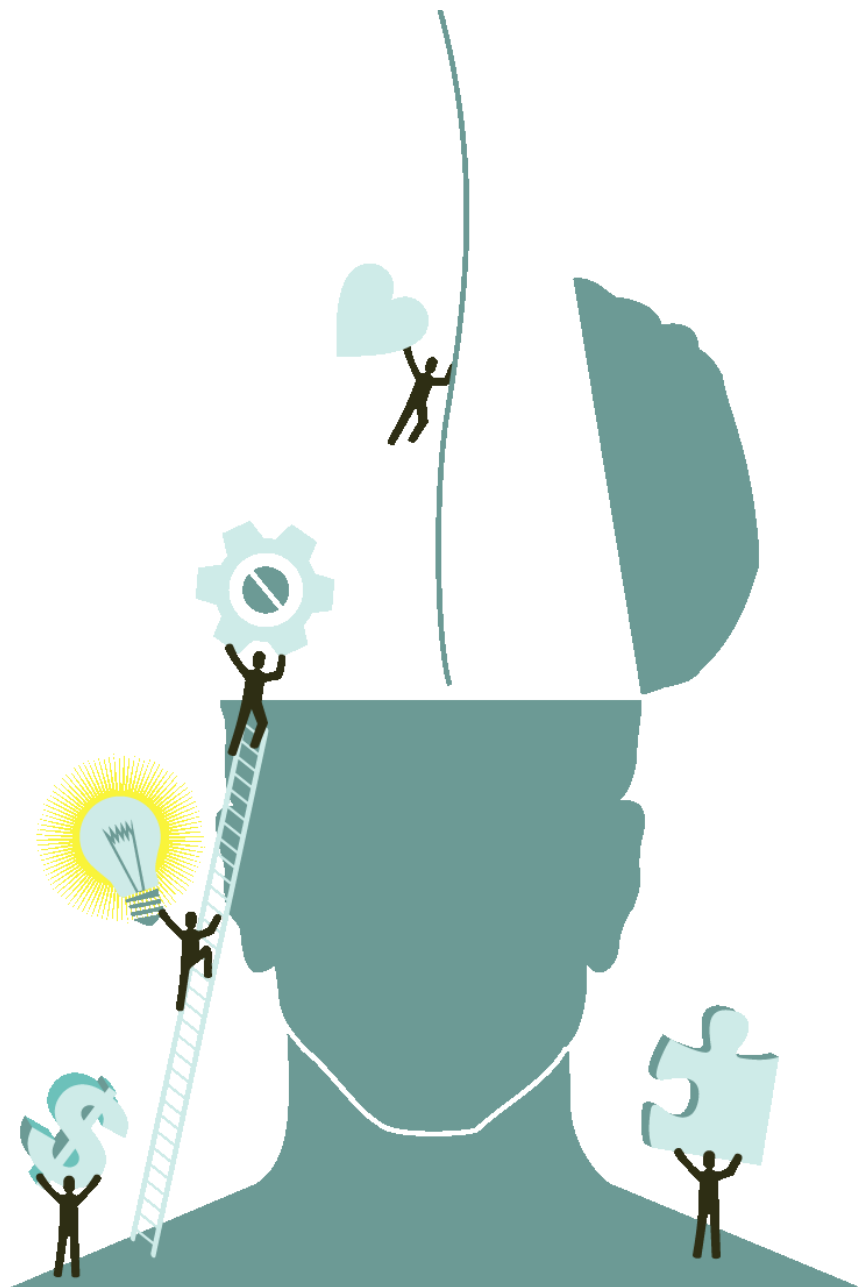
The Tendency to Get Extreme Consequences from Confluences of Psychological Tendencies Acting in Favour of a Particular Outcome

WHAT IS IT? The dictionary definition of 'lollapalooza' is: one that is extraordinarily impressive; also: an outstanding example. The lollapalooza tendency comes into action when more than one of the previously mentioned tendencies work together towards an outcome. For instance, when once asked what brought about the current economic mess, Munger replied, "It was a lollapalooza event – a confluence of causes that is how complex systems work."

OFTEN FOUND IN: Instances where more than one psychological tendencies work towards a result

The lollapalooza effect can be used with positive benefits, for example, in the Alcoholics Anonymous programme. Says Munger, "The system of Alcoholics Anonymous: a 50 per cent no-drinking rate outcome when everything else fails? It's a very clever system that uses four or five psychological systems at once toward, I might say, a very good end."

One of the more pronounced examples of the lollapalooza effect is visible in auctions, wherein a number of tendencies work together – often, not in the interest of the bidder. Says Charlie Munger, "Well the open-outcry auction is just made to turn the brain into mush: you've got social proof, the other guy is bidding,



you get the reciprocation tendency, you get the deprivation super-reaction syndrome, the thing is going away... I mean it just absolutely is designed to manipulate people into idiotic behavior.”

Introduction

What is the importance of studying and understanding the lollapalooza effect? It makes you think how the different tendencies work together and cause a response. Let's see what Munger says. He says, “Why would anyone think his study of psychology was adequate without his having endured the complexity involved in dealing with intertwined psychological tendencies?”

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Open-outcry auctions exhibit the lollapalooza effect. In them, you see social proof, reciprocation and deprivation superreaction.

IN INVESTING: Like in any other field, it is important to understand how these tendencies work together to affect your choices and decisions. If you think you can ignore the lollapalooza effect when it comes to investing, here's a final piece of advice from Munger, “Maybe you think this doesn't happen in picking investments? If so, you're living in a different world than I am.” Avoid this tendency and get better at investing.



Introduction



“Great investing requires a lot of delayed gratification.”

- Charlie Munger

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