

Keeping calm is no myth when it comes to investing wisely

Charles Darwin married his cousin, Emma Wedgwood, in January 1839 – but not before giving it some serious thought. In fact, on the back of a letter from a friend he carefully compiled a list of pros and cons regarding marriage and its potential impact on his work.

A wife, Darwin ruminated, would provide “children, companionship, the charms of music and female chitchat”. She would be “an object to be beloved and played with”, although conceding that a wife was in this respect only “better than a dog anyhow”. In his cons column Darwin noted the prospect of “being forced to visit relatives, and to bend in every trifle”; “The loss of freedom to go where one liked, the conversation of clever men at clubs”.

I suspect most people would find this moral or prudential algebra as Benjamin Franklin referred to it, as distasteful at best. We are on dangerous ground here. Setting out pros and cons, attaching weights to each consideration and arriving at a balanced judgment, is pretty callous in relation to matters of the heart. But can we draw any useful lessons from Darwin in relation to more mundane matters, such as investing perhaps?

I think we can. But you will take some convincing.

Daniel Kahneman, author of *Thinking, Fast and Slow*, is a renowned psychologist and winner of the Nobel prize in economics. He refers to our brain as having two systems for thinking: “System 1” is fast, instinctive and emotional; “System 2” is slower, more deliberate, and logical (as demonstrated by Darwin’s process for marriage assessment).

One of Kahneman’s favourite examples of System 1 thinking is what would happen if you heard an upper-class British voice say: “I have large tattoos all down my back.”

“People who speak with an upper-class British accent don’t have large tattoos down their back,” Kahneman says.

GARY CONNOLLY COMMENT



“So the brain brings to bear all the world knowledge that’s involved, and registers that there is an incongruity here within three- or four-tenths of a second.”

It’s the same response you’d get if you heard a male voice say: “I think I am pregnant.”

System 2, on the other hand, has to do with orderly computations, rules and reasoning. So, if you’re asked to multiply 24 by 17 in your head, that’s when System 2 takes over.

The automatic system of decision-making evolved because it helped people make rapid decisions in situations where survival was at stake. For example, those whose ancestors had a propensity to see sabre-toothed tigers everywhere – even where there was none – tended to live long enough to pass that genetic inheritance down to future generations. The false positive (seeing the tiger that was not there) was far less harmful than the false negative (not seeing the tiger that was). This gave rise to a propensity to overweight negative information that had survival value.

This mechanism in the brain that evolved to provide an



ongoing assessment of threat level has not been turned off, although its value on Wall Street today is far less than on the savannahs. What might have saved our ancestors from becoming lunch has bestowed upon us a similar fate only at the hands of greedy capitalists.

The automatic system of thinking is fast because it uses short cuts (heuristics), which in turn give rise to biases, including anchoring, loss aversion and overconfidence to name but a few. Anchoring wreaks havoc with, among other things, our thinking in relation to finance.

Some have suggested that cognitive biases might be harnessed in ways that “nudge” individuals in the direction of better decision-making.

A compelling example can be found in an examination of the respective organ donation rates of Germany and Austria. According to the European Social Survey, these two countries are extremely similar from a social and cultural perspective. However, the organ donation rate in Germany is only 12% compared with an Austrian donor rate of 99%. The explanation can be found in the

structure of the choices on offer in each country. Austrians are automatically organ donors unless they opt out, while Germany requires donors to opt in. Default options and inertia are incredibly powerful forces when it comes to making and acting on decisions. This is an example of one of the findings from behavioural finance.

So what are the practical take-aways for investors?

The “nudge” I suggest here is good objective advice so that you commit to a plan crafted during a period of calm – a sort of “Ulysses contract” that binds you to a course of action in the future and saves you from yourself.

During the Trojan wars, the Sirenuse islands were famous for being home to the sirens, whose songs were so irresistibly seductive that seamen felt impelled to fling themselves into the waters.

Ulysses instructed his crew to fill their ears with wax and then tie him securely to the mast and to ignore his pleas to be released. Ulysses heard the sirens’ songs, the crewmen ignored his entreaties to be untied. Ulysses had committed himself to a rational course of action at a neutral time. Another example of the reflective mind.

A modern-day take on the Ulysses contract would be to draft an investment plan, called a policy statement. Investment policies are meant to be an enduring guide in an ever-changing external environment. They should normally only change for structural or fundamental reasons, not due to ephemeral changes in the environment such as recessions or financial market fluctuations.

Slow and meticulous thinking pays off. After all, Darwin and Emma Wedgwood had 10 children and remained happily married for 43 years until his death in 1882.

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Ulysses relied on rational thinking to deal with the sirens