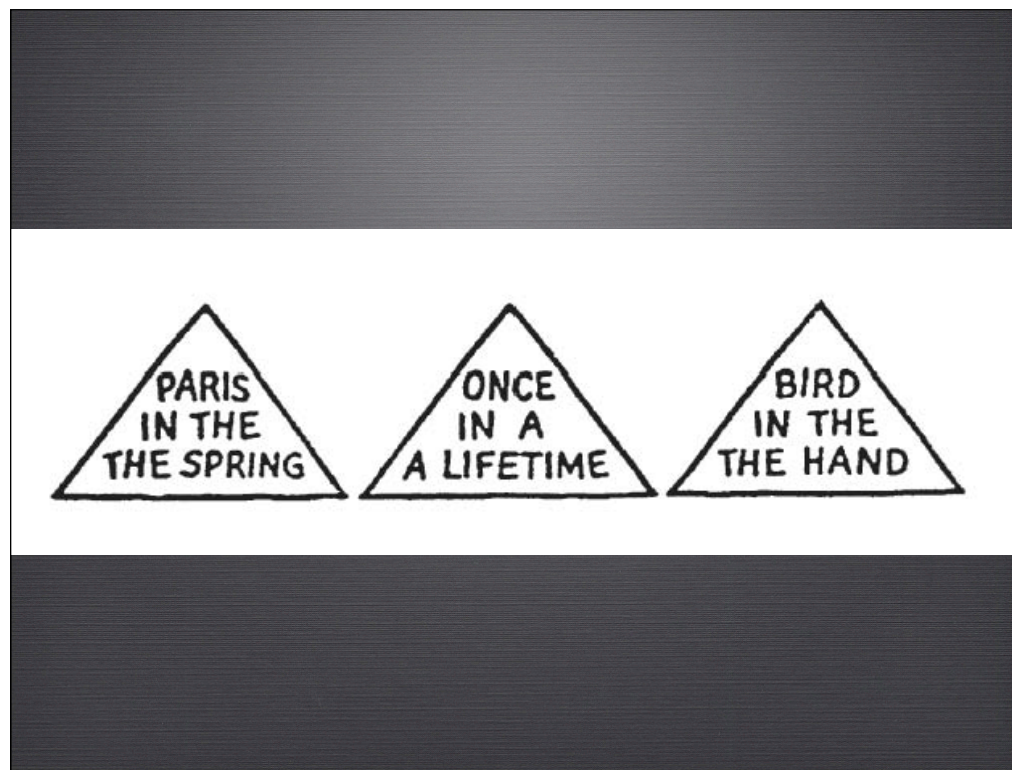


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Example # 1

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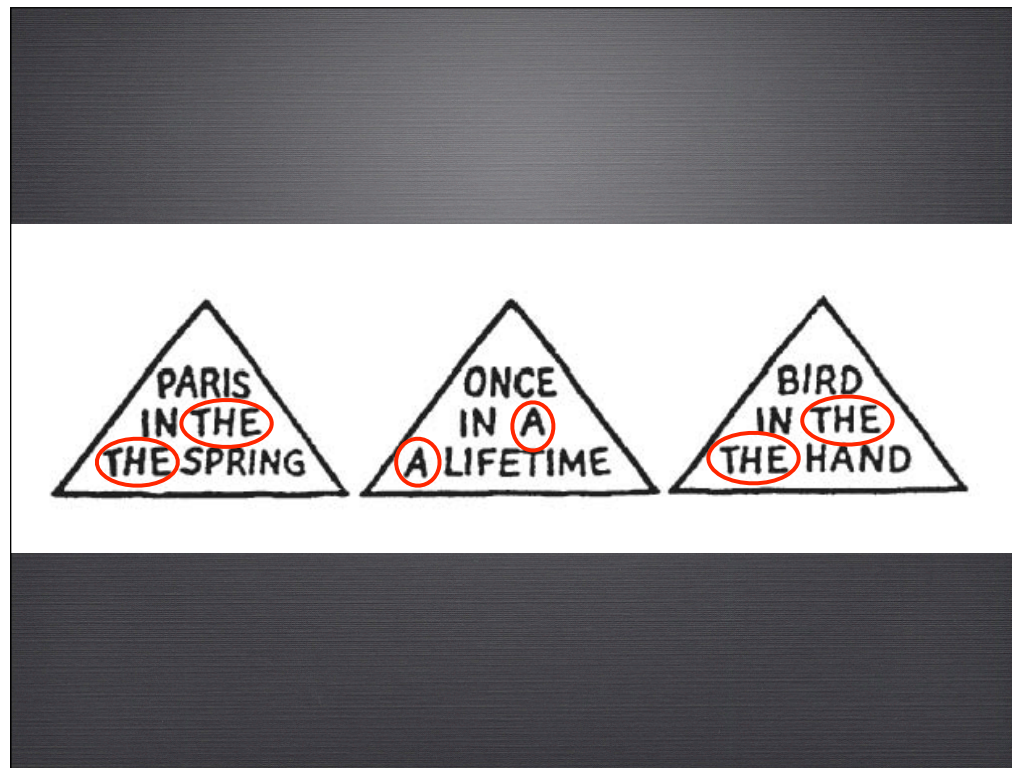
2



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3

Read aloud quickly what you see on the screen.
Do it twice.



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Most of you got it wrong!

Example # 2

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A BAT AND BALL TOGETHER COST RS 110.

THE BAT COSTS RS 100 MORE THAN THE
BALL.

HOW MUCH DOES THE BALL COST?



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Most people get this one wrong too because they allow their minds to jump to conclusions.

$$1 \text{ BAT} + 1 \text{ BALL} = \text{Rs } 110$$

$$1 \text{ BAT} - 1 \text{ BALL} = \text{Rs } 100$$

$$\text{THEREFORE, } 2 \text{ BATS} = 210$$

$$\text{THEREFORE, } 1 \text{ BAT} = \text{Rs } 105$$

$$\text{THEREFORE, } 1 \text{ BALL} = \text{Rs } 5$$



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Reflexive vs. Reflective Brain.

The reason why people get it wrong is because they “jump to conclusions” using the reflexive parts of their brains.



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Reflexive Brain is effortless, automatic, fast, but can lend itself to errors.

Its also the reason why you are alive today. Your ancestors, who learnt to run away at the first sign of danger, were able to increase their chances of survival until at least they pro-created. If even one of your ancestors had died before pro-creating, you won't be here today. But you are.

Reflexive brain is VERY useful. But it also leads to mistake.

Human Evolution hasn't kept pace with rapid change since industrialization.



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Reflective Brain is effortful, reasoned, slow, logical, and less prone to error

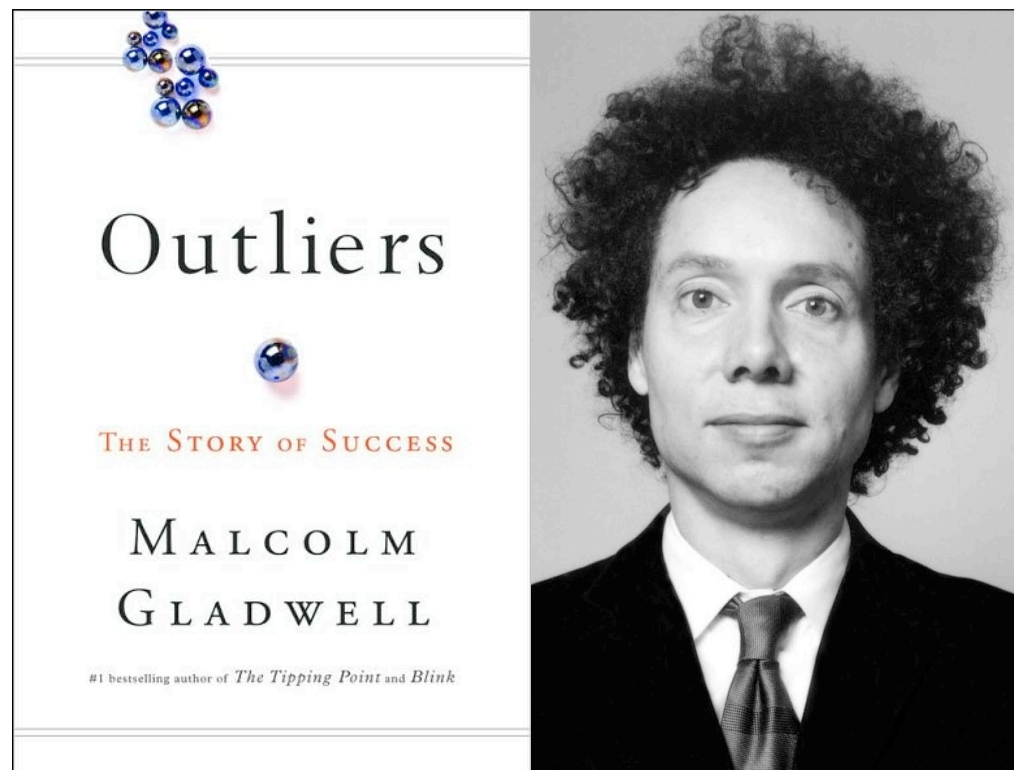


DIRECT EXPERIENCE
Vs.
VICARIOUS EXPERIENCE

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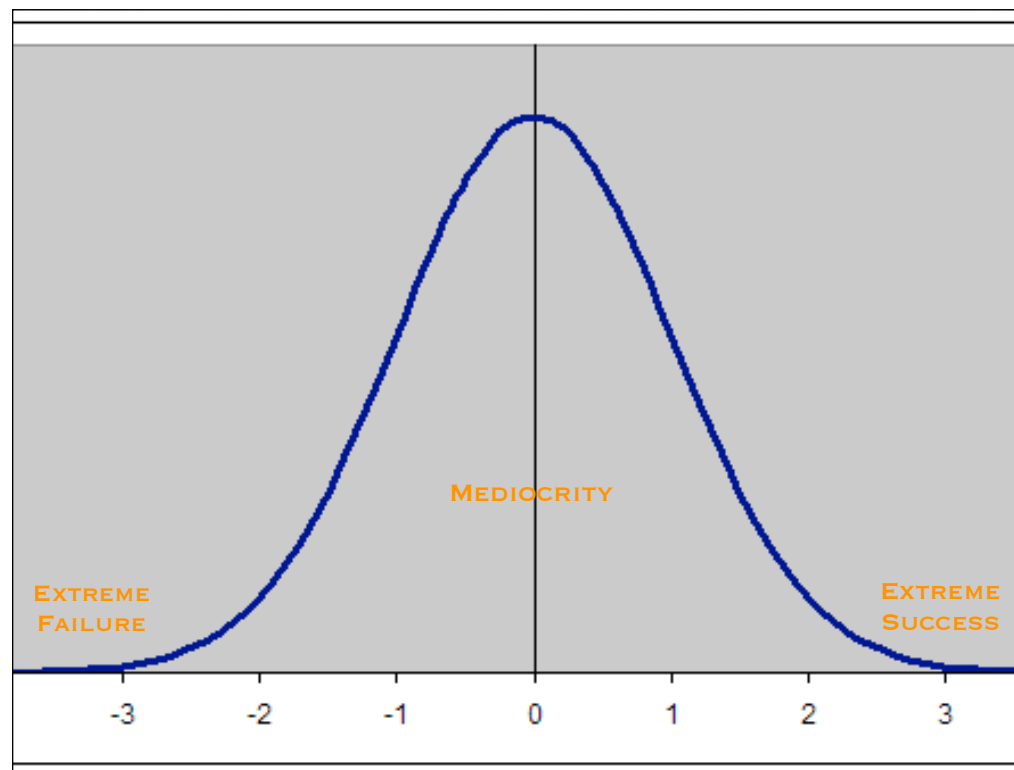
Learning comes from two types of experiences.
Direct experience



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The key to success in any field is, to a large extent, a matter of practicing a specific task for a total of around 10,000 hours – Gladwell.

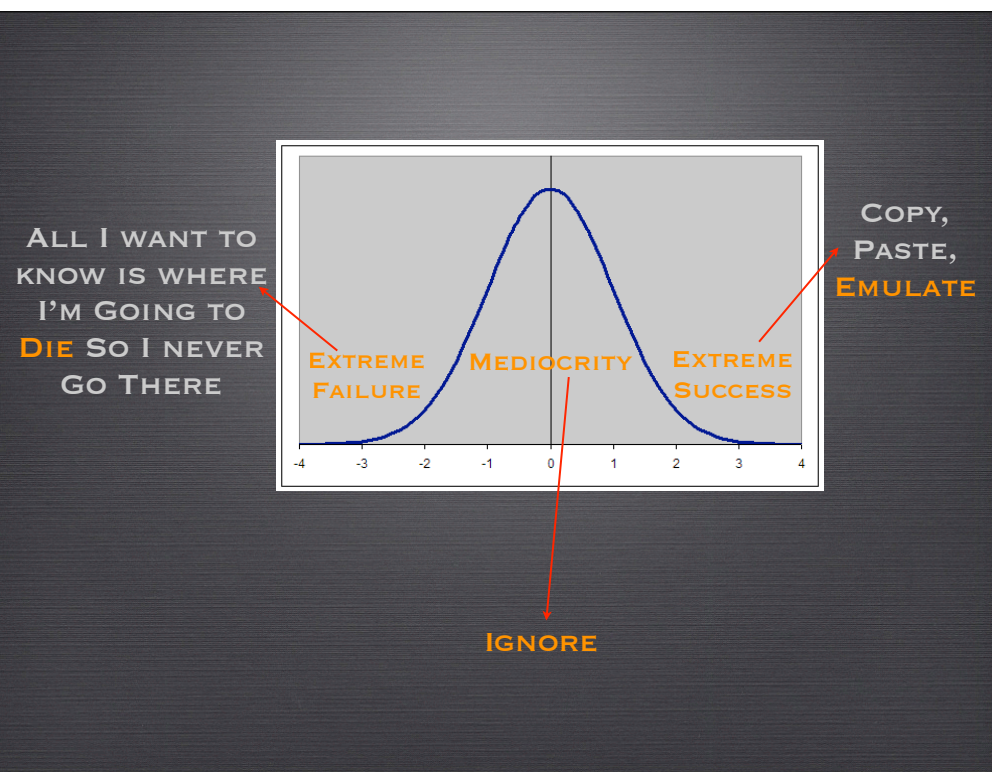


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VICARIOUS EXPERIENCE

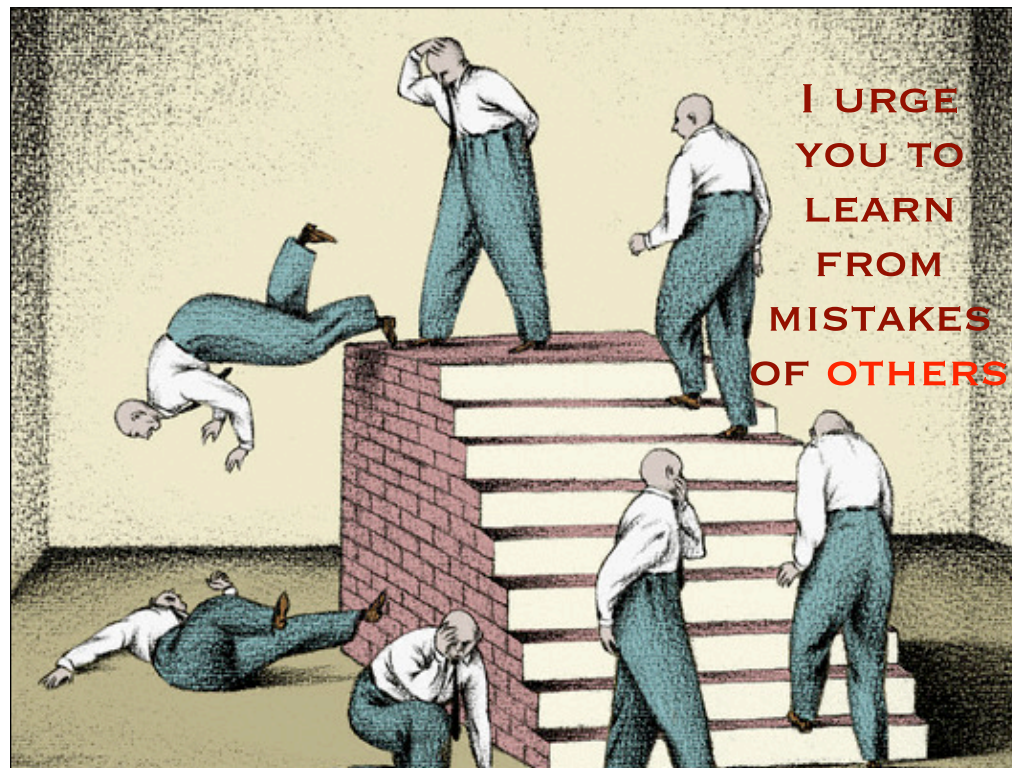
Most vicarious Learning Comes from studying extremes



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INSTEAD OF
FOCUSING ON
BECOMING TOO
SMART, I URGE
YOU TO FOCUS ON
AVOIDING
FOOLISH
BEHAVIOR





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“You don't have to pee on an electric fence to learn not to do it.”– Charlie Munger



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Learn from mass folly



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How I get my vicarious experience although now I have a kindle. I encourage you to get one.

Example # 3

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Key Word: Vivid

9/11 media coverage was very vivid. What did that do?



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Approximately 3,000 people died in september 11 attacks.
An additional 1,500 died due to increased ROAD Travel because of
dread risk.



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What caused the dread risk?

The extraordinarily vivid images of the disasters caused mass fear of flying. Key word here is VIVID. But there is a general principle at work here. What is it?

Example # 4

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The next three slides will contain some very “interesting data”

Studies show that motorists who send or receive a text message have a tendency to take their eyes off the road for five seconds to do so. That is enough time for their car to travel more than the length of a football field at highway speeds.

The [Virginia Tech](#) Transportation Institute found in a study that truckers sending text messages while driving are 23 times likelier to cause a crash or near crash than a trucker not texting. Studies using a driving simulator at the [University of Utah](#) found that car drivers who text face an eight times greater crash risk.

Studies show that talking on a cellphone while driving is as risky as driving with a .08 blood alcohol level — generally the standard for drunken driving — and that the risk of driving while texting is at least twice that dangerous. Research also shows that many people are aware that the behavior is risky, but they assume others are the problem.



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This Data is SO boring!
How do we make it more interesting?
Enter Chief Constable of Gwent, Wales



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<http://www.youtube.com/watch?v=Q0ukd7xTQ9g>

<http://www.msnbc.msn.com/id/32657455/>



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What's the general principle at work



VIVIDNESS can also **SAVE**

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What's the general principle at work here?



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PSYCHOLOGICAL TENDENCY # 1

AVAILABILITY BIAS

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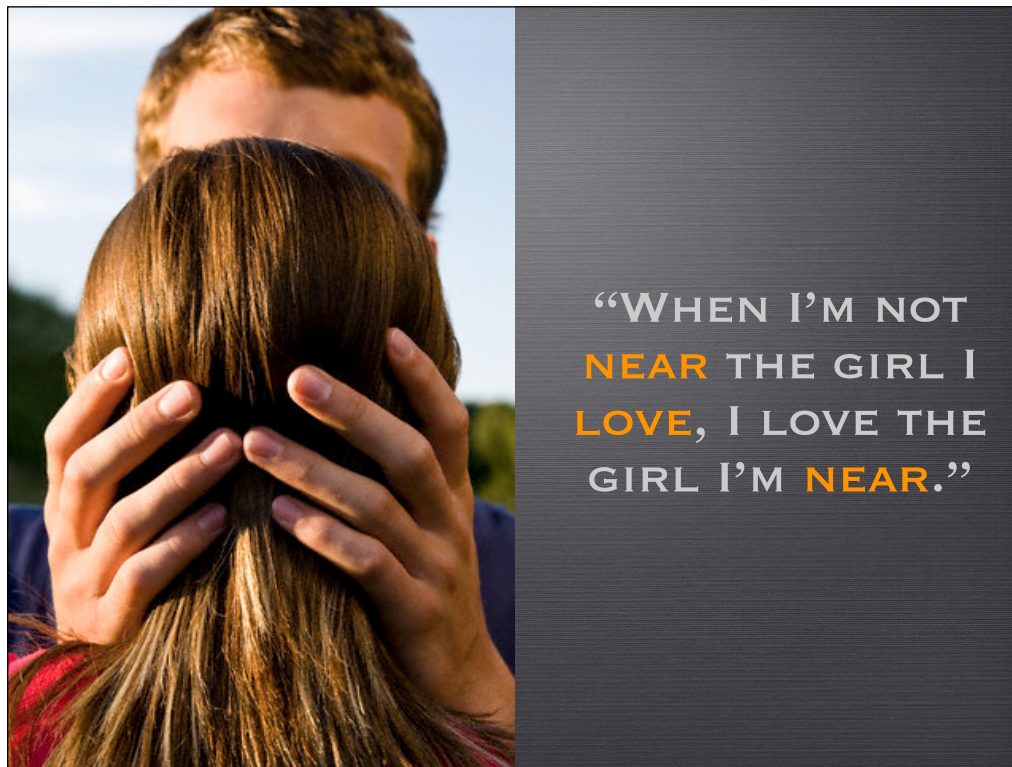
34



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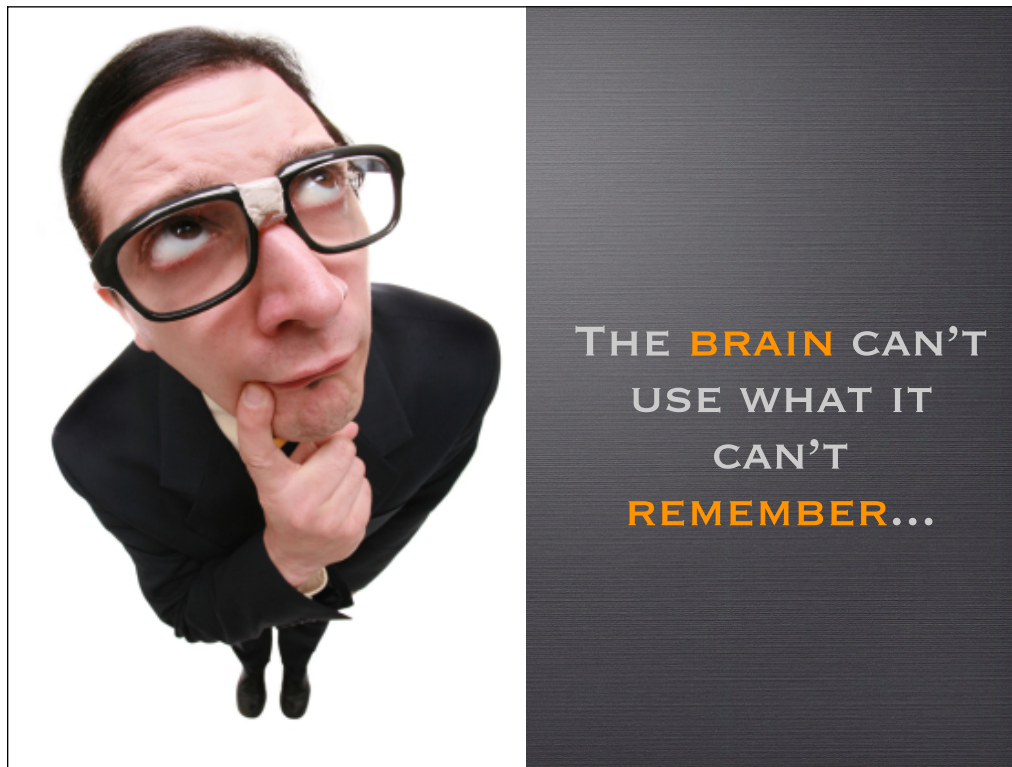
The human brain tends to drift into working with what's easily available to it.



“WHEN I’M NOT
NEAR THE GIRL I
LOVE, I LOVE THE
GIRL I’M **NEAR**.”

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...OR WHAT IT IS
BLOCKED FROM
RECOGNIZING
UNDER THE
INFLUENCE OF
CERTAIN
PSYCHOLOGICAL
TENDENCIES



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THE RESULT? **MIND** TENDS TO **OVER-WEIGH** WHAT'S **EASILY AVAILABLE** TO IT



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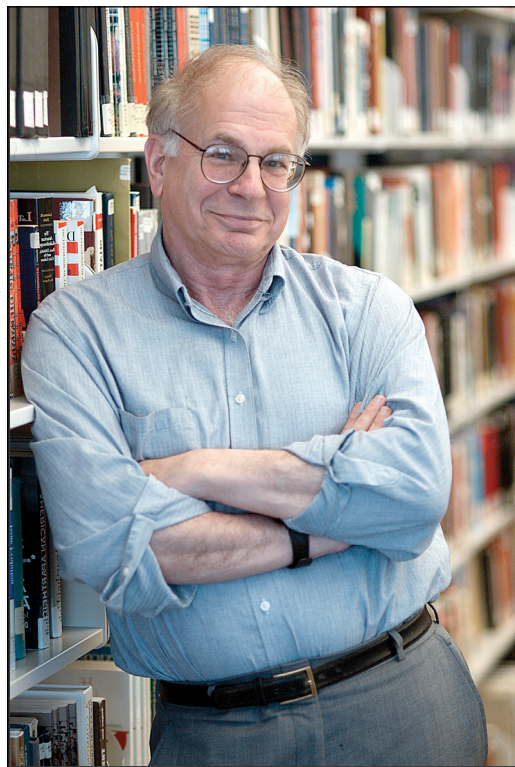
Tversky-Khaneman video on Availability Bias

“PEOPLE ASSESS THE
FREQUENCY,
PROBABILITY, OR
LIKELY CAUSE OF AN
EVENT BY THE DEGREE
TO WHICH INSTANCES
OR OCCURRENCES OF
THAT EVENT ARE
READILY “AVAILABLE”
IN MEMORY.”-DANIEL
KAHNEMAN



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“AN EVENT THAT
EVOKES **EMOTIONS**
AND IS **VIVID**, **EASILY**
IMAGINED, AND
SPECIFIC WILL BE
MORE **AVAILABLE** THAN
AN EVENT THAT IS
UNEMOTIONAL IN
NATURE, BLAND,
DIFFICULT TO IMAGINE,
OR VAGUE.”-DANIEL
KAHNEMAN

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People remember vivid images
Which is why this presentation is made vivid

Example # 5

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The next three slides will contain some very “interesting data”



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Physicians response to Surgeon General's report linking cancer to smoking

PROBABILITY
OF A
PHYSICIAN
SMOKING IS
DIRECTLY
RELATED TO
THE DISTANCE
OF THE HER
SPECIALITY
FROM THE
LUNGS!



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Example # 6

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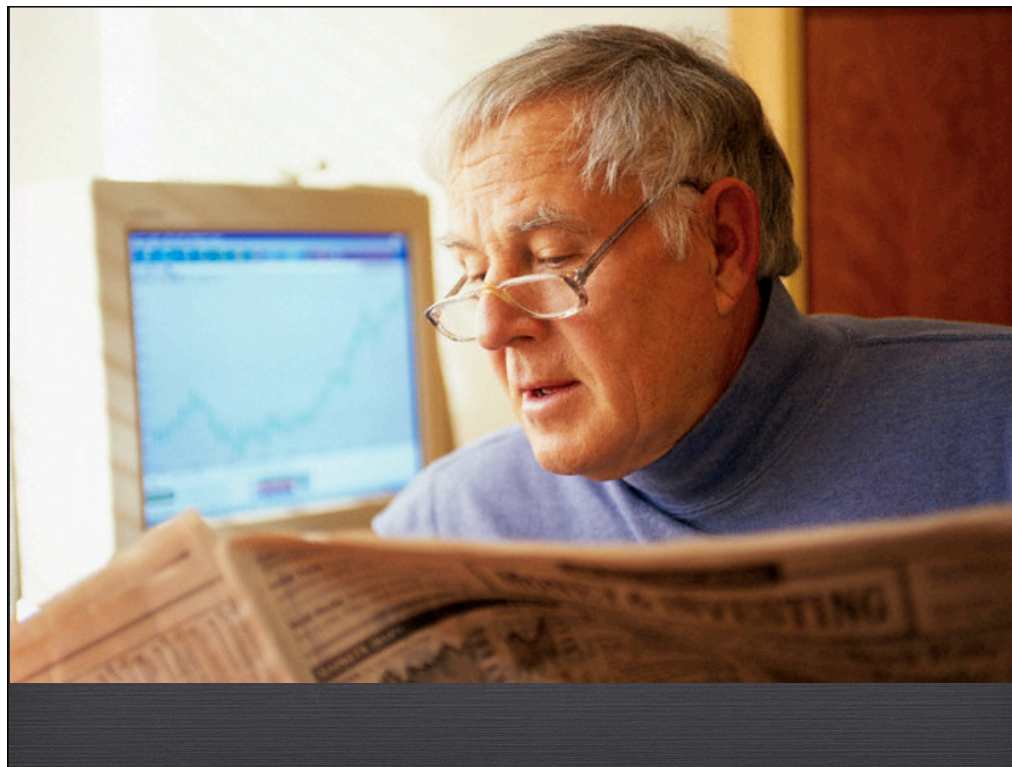


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Before boarding a flight people are prepared to pay more when offered a flight insurance policy to cover against “terrorism insurance” than for a general policy covering all risks.

Clever, psychologically astute insurance companies can use this to manipulate people.



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RECENCY

Our most recent experience tends to carry more weight in our heads than old experiences.

Example # 7

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Recent (and also vivid) events.
Recency + vividness = lethal combination

And if you get this idea right, you'd understand the importance of taking the opposite view of the crowd when the crowd is obviously wrong.

AFTER the event the RISK went DOWN

Example # 8

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Purchase of earthquake insurance increases greatly after the occurrence of an earthquake and declines steadily as the memory of the event fades.

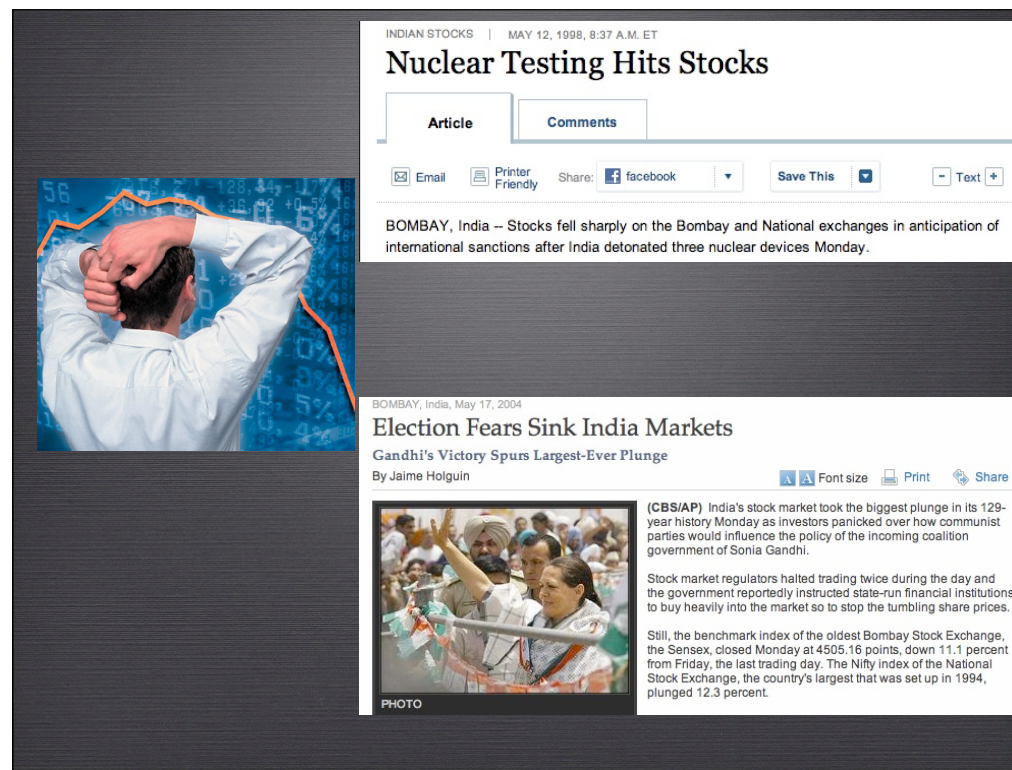
Similar behavior has been observed for floods and food insurance.

Notice this combines with VIVIDNESS

Example # 9

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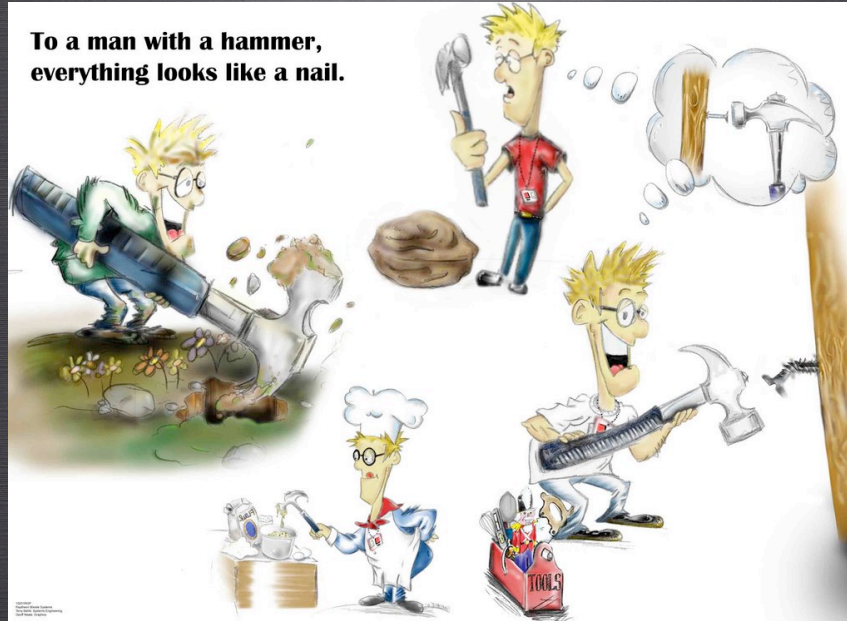
57

The best time to buy is when there is blood in the streets.
While I am not a great fan of DCF (more about that later), it is at such times, that thinking in terms of DCF makes sense. The value of an asset is equal to the present value of cash flows. So only a change in two variables can change value. If these changes haven't occurred but price has crash, this spells OPPORTUNITY

Biggest losing days in stock markets typically mean lucrative opportunities to invest.

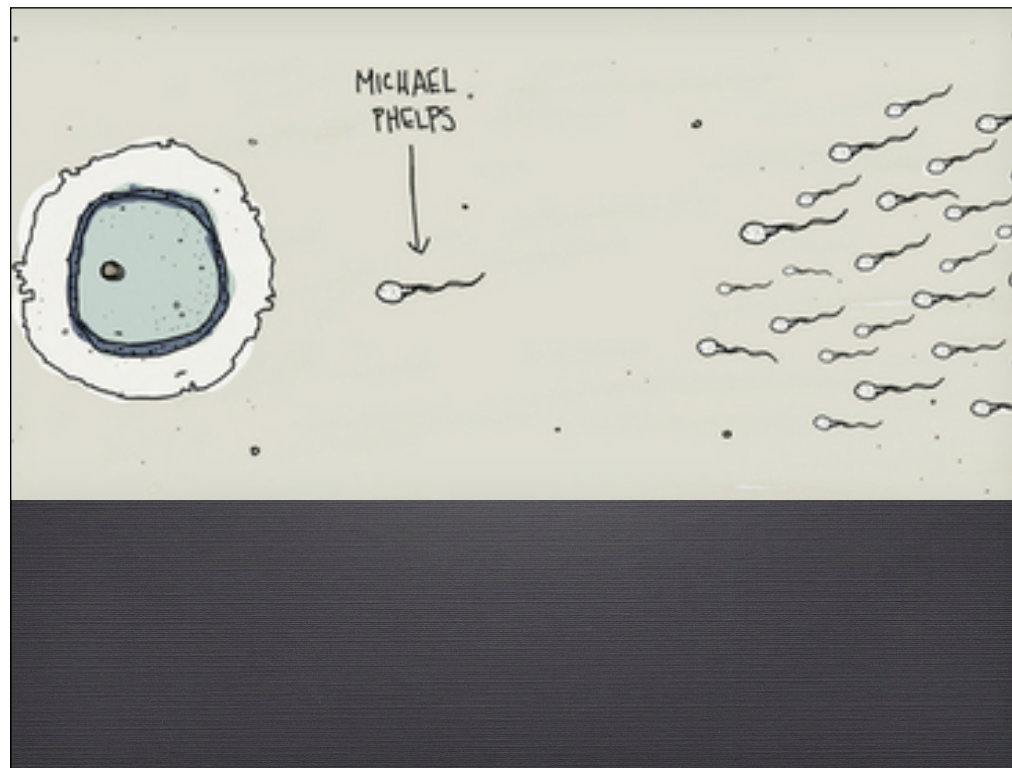
FIRST-CONCLUSION BIAS

**To a man with a hammer,
everything looks like a nail.**



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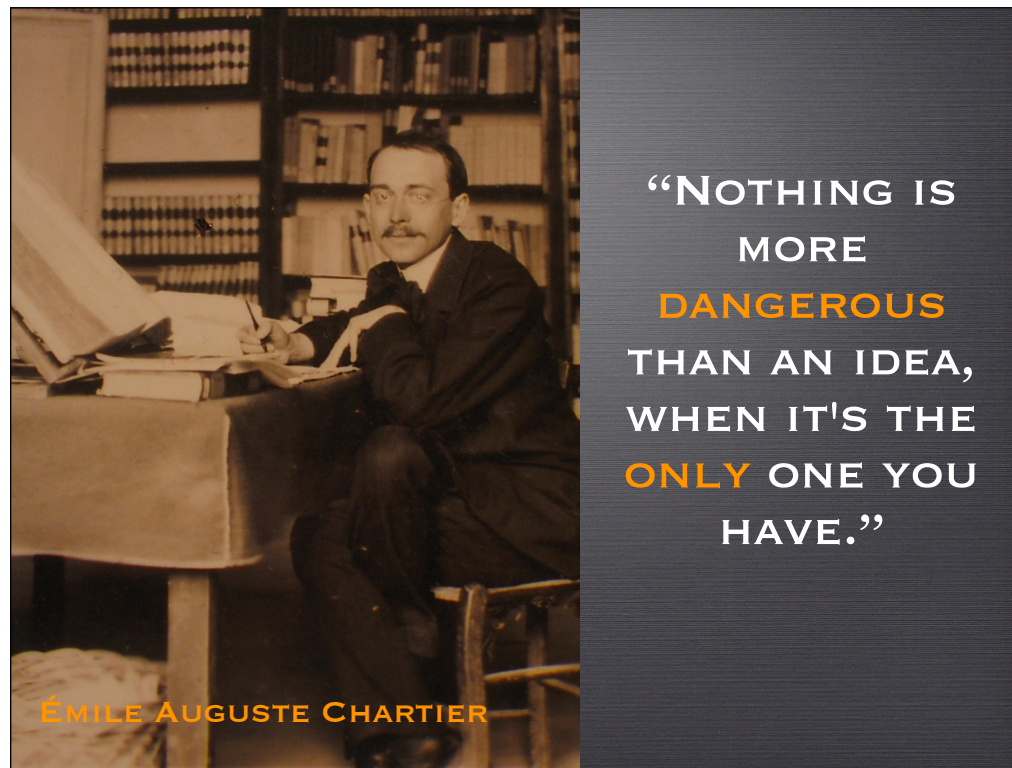
58



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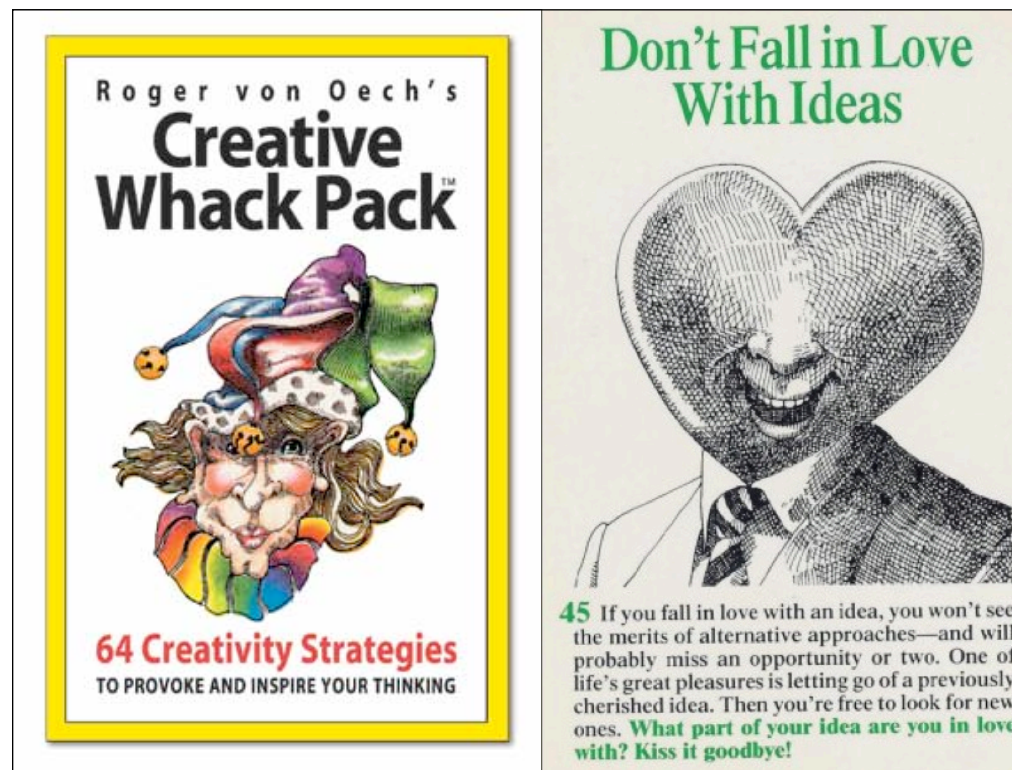
The human mind is like the human egg. Out of a billion sperms racing towards the egg, only one succeeds in entering and fertilizing it. As soon as the fastest swimming sperm enters the egg, the egg immediately shuts down to stop any other sperm from entering. We answer questions which start with the word “why” by grabbing the first answer that comes to mind. Example: Steel Price Hike, Impact on Auto Stocks



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If you want to have good ideas, you should have LOTS of IDEAS

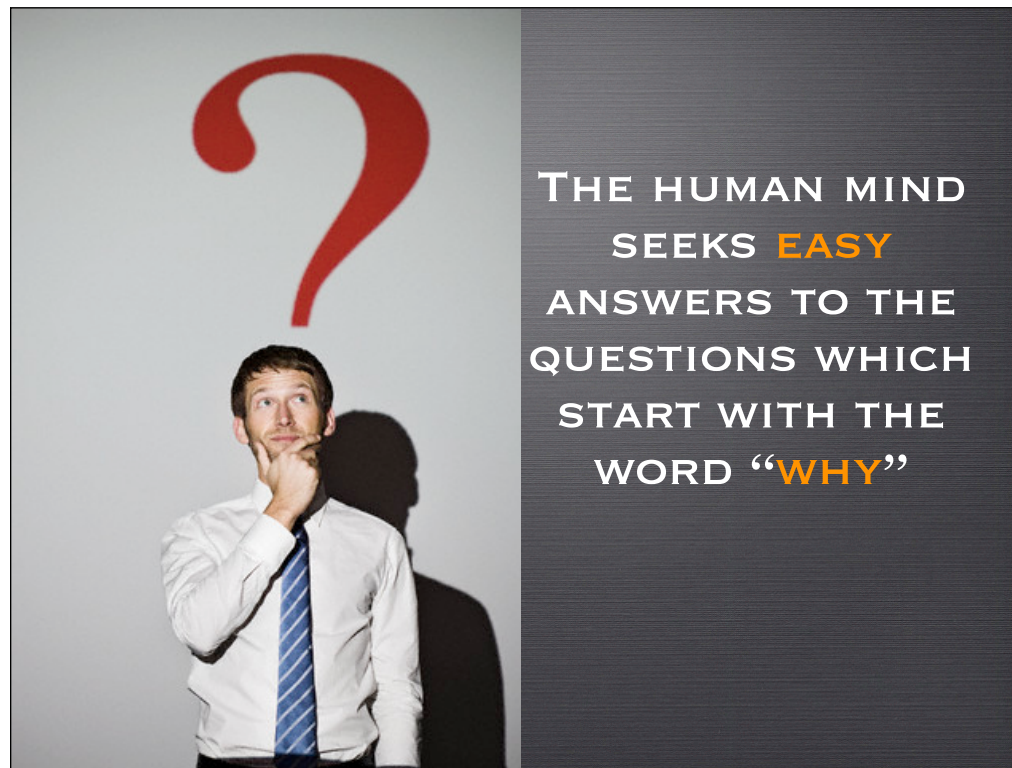


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Everyone should get a pack of these wonderful cards:

[Amazon.com: Creative Whack Pack \(9780880793582\): Roger Von Oech: Books](https://www.amazon.com/Creative-Whack-Pack/dp/0780880793582)



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Example # 10

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A STOCK IS SELLING BELOW CASH!

WHY SHOULD I BUY THIS STOCK?

BECAUSE ITS CHEAP!

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Well, so what? Under what circumstances would this be a mistake?

Can you think of three reasons why you could be wrong?

You really have to FORCE yourself to come up with 3 reasons which can prove you wrong.

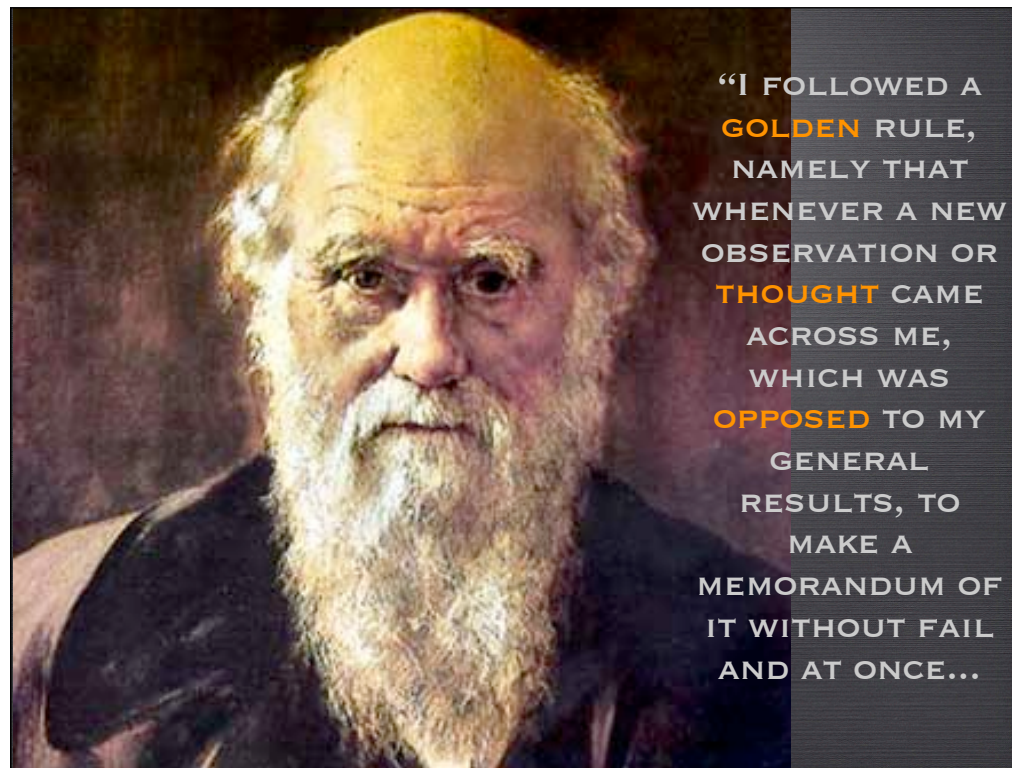


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Give me three reasons why buying it would be a mistake

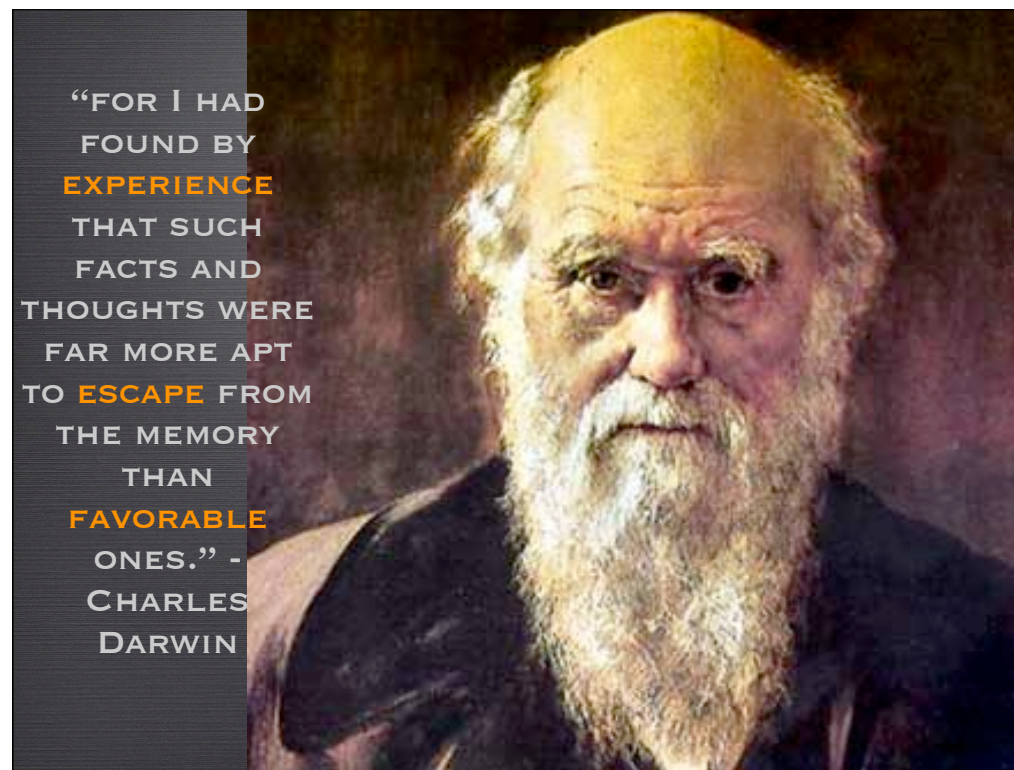
1. Fraud
2. Value Trap
3. Bubble market



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Charles Darwin is a wonderful example, according to Mr. Munger, to study.



“FOR I HAD
FOUND BY
EXPERIENCE
THAT SUCH
FACTS AND
THOUGHTS WERE
FAR MORE APT
TO **ESCAPE** FROM
THE MEMORY
THAN
FAVORABLE
ONES.” -
CHARLES
DARWIN

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Direct Experiences

We overweigh direct experience and under-weight vicarious experience. What we see for ourselves with our own eyes, hear from our own ears, has a greater impact than what we see or hear through others
I saw it with my OWN Eyes!



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“But I know a man who smoked three packs of cigarettes a day and lived to be 99!”

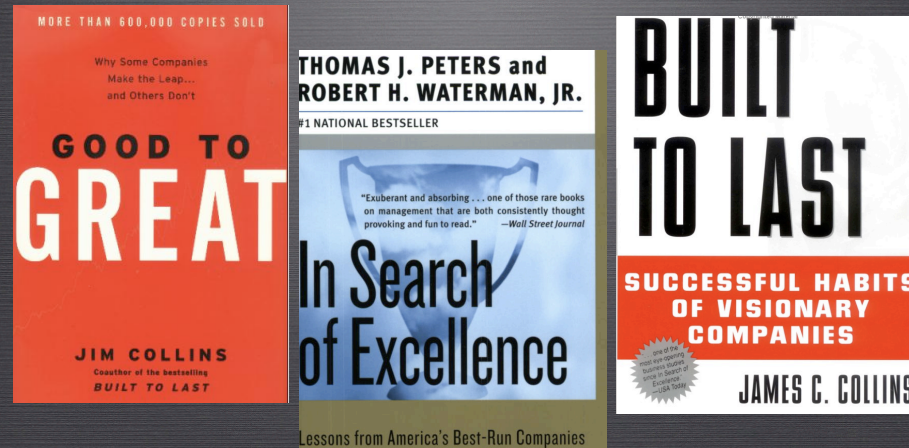


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If we personally see people who drowned, our assessment of the riskiness of swimming in open waters will be much higher than the correct probability.

Problem of **Silent** Evidence



You only see the **winners**!

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You can't learn about success by reading these books because they don't tell you about the companies who had same attributes but went belly up.

Read "The Halo Effect"

<http://www.amazon.com/Halo-Effect-Business-Delusions-Managers/dp/0743291263/>

<http://www.britannica.com/bps/additionalcontent/18/25996994/Misunderstanding-the-Nature-of-Company-Performance-THE-HALO-EFFECT-AND-OTHER-BUSINESS-DELUSIONS>

“WE HAVE NEVER SEEN ANYTHING LIKE THIS,” SAID ANALYST GLENN SCHORR, WHO COVERS THE INVESTMENT BANKS FOR UBS AG. “THERE HAVE BEEN TOUGH SITUATIONS LIKE LONG-TERM CAPITAL MANAGEMENT AND THE CRASH OF 1987, BUT THE PROBLEM HERE IS THERE IS LEVERAGE IN THE SECURITIES UNDER THE MICROSCOPE AND IN THE BANKS THAT OWN THEM. AND TO TRY AND UNWIND IT ALL AT ONCE CREATES A ONE-WAY MARKET WHERE THERE ARE ONLY SELLERS, AND NO BUYERS.” - WSJ, SEPTEMBER 14, 2008

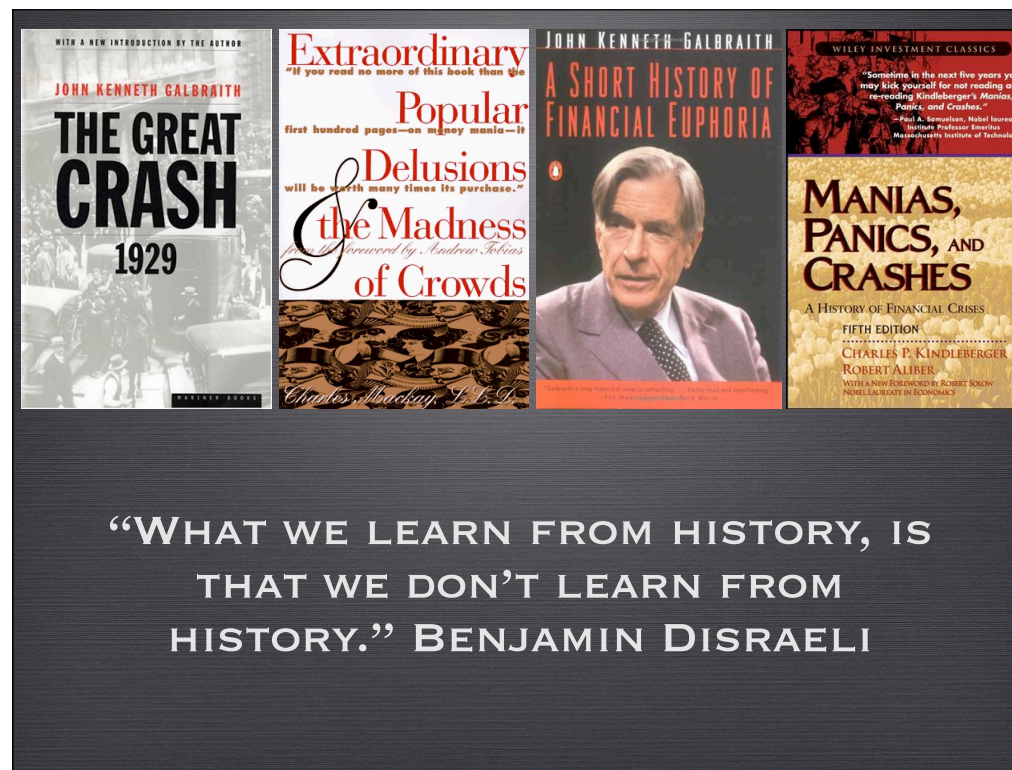
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He has never SEEN SOMETHING LIKE IT
But financial history is littered with examples after examples of similar situations...

This is an example of underweighing vicarious experience.

Just because YOU HAVEN'T SEEN ANYTHING LIKE THIS, does NOT mean its never happened before.

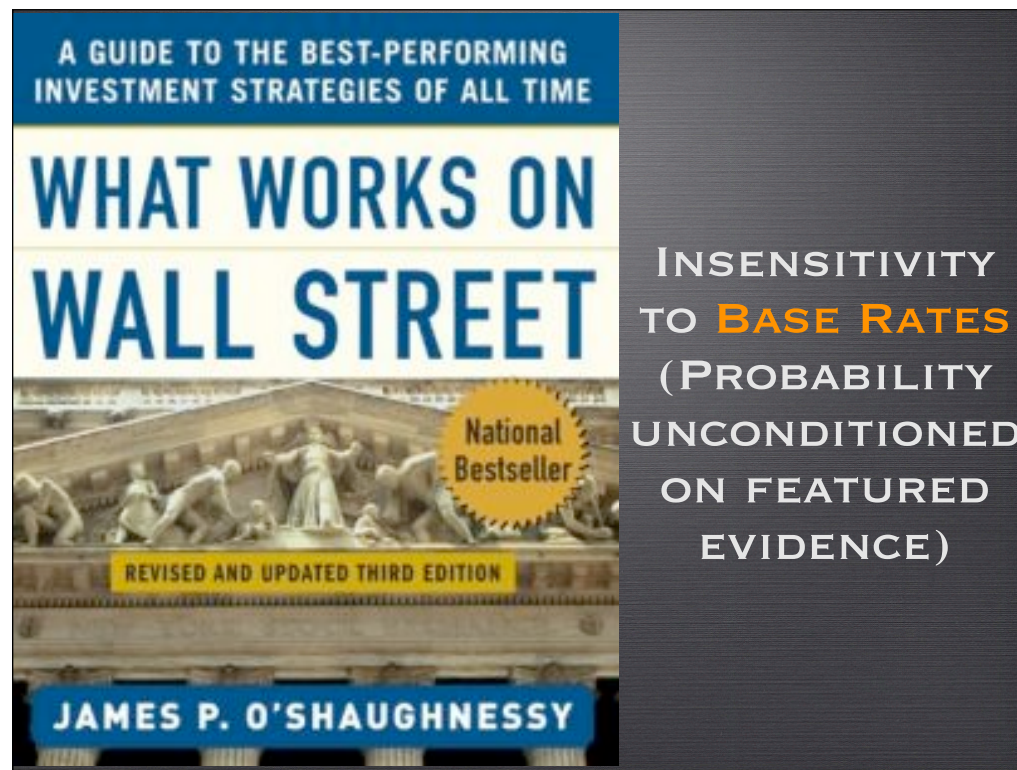


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You will be required to read these books and be prepared to do a quiz (closed book) on it very soon.

Here is your chance to acquire some extremely valuable vicarious experience...



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Base rate is the probability unconditioned on featural evidence, frequently also known as prior probabilities. For example, if it were the case that 1% of the public are "medical professionals" and 99% of the public are not "medical professionals," then the base rates in this case are 1% and 99%, respectively.



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From “What Works on Wall Street”

“Base rates are boring but are amongst the most illuminating statistics that exist.”

100 people – 70 lawyers 30 engineers. When no additional info is provided and asked to guess occupation of randomly selected 10, people use base rates – they say 7 are lawyers and 30 are engineers.

When worthless data is added – Dick is highly motivated 30 year old man who is well liked by his colleagues people largely ignore the base rate in favor of their “feel” for the person.



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From “What Works on Wall Street”

When stereotypical info is added e.g. Dick is 30 years old married shows no interest in politics or social issues and likes to spend free time on his many hobbies which include carpentry and math puzzles, people TOTALLY ignore the base rate and bet Dick is an engineer.

Base rates are boring – experience is vivid and fun.

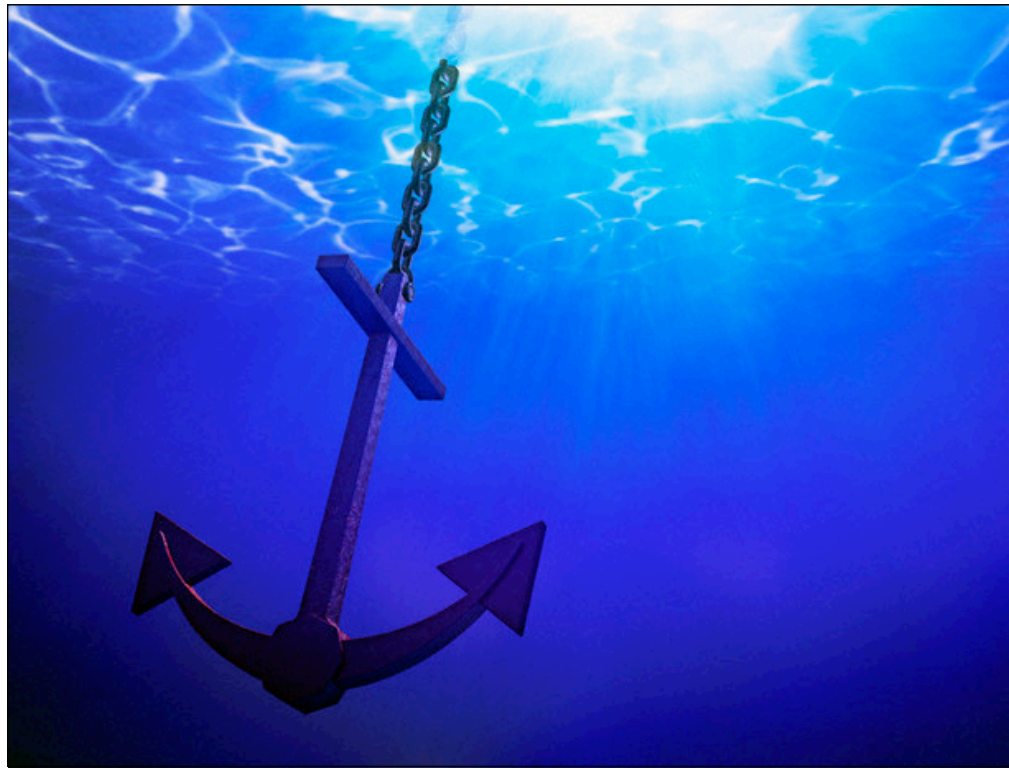
The only way someone will pay 100 times earnings for a stock is because it has a tremendous “story”. Never mind that the base rate of investing in high P/E stocks is horrible – the story is too compelling that people throw base rates out of the window.



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Human nature makes it virtually impossible to forgo the specific info of an individual case in favor of the results of a great number of cases. we are interested in THIS stock and THIS company, not with this CLASS OF STOCKS or this CLASS OF COMPANIES. Large numbers mean nothing to us. But they should



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Anchoring Bias as a subset of Availability Bias

We need anchors

Something (Somebody?) to latch on to...

What should we latch on to?

What are the right anchors?

What are the wrong anchors?



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Video Clip on Anchoring



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Money lost in wallet.

Your wallet had Rs 1,000 and now Rs 100 is missing.

You are feeling miserable because you are latching on (anchoring) to money in the wallet and not in the bank. If the money in the bank (your wealth) is large, then this loss is inconsequential.

Stop feeling miserable because of wrong anchors in life...

ANCHORS

PAR VALUE
52 WEEK LOW
ALL TIME HIGH
LOW ABSOLUTE PRICE
SUNK-COSTS
STOCK PRICE ITSELF

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Its foolish to think a stock is cheap just because its selling below par or below 52 week low or is selling at an absolute low price.

A stock selling at Rs 5 may be more expensive than one selling at Rs 500.

The right anchor to latch on you is value.

OVERWEIGHING WHAT CAN BE COUNTED



*“You’ve got a complex system and it spews out a lot of wonderful **numbers** that enable you to **measure** some factors.*”

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People tend to overweigh things that can be easily counted.



*“But there are **other** factors that are terribly **important**, [yet] there’s no **precise** numbering you can put to these factors...”*



*“You know they’re **important**, but you don’t have the numbers. Well practically everybody (I) **overweighs** the stuff that can be numbered, because it **yields** to the statistical techniques they’re taught in academia...”*



“AND (2) DOESN’T MIX IN THE
HARD-TO-MEASURE STUFF THAT MAY
BE MORE IMPORTANT. THAT IS A
MISTAKE I’VE TRIED ALL MY LIFE TO
AVOID, AND I HAVE NO REGRETS
FOR HAVING DONE THAT.”



“TO A MAN WITH A **HAMMER**,
EVERYTHING LOOKS LIKE A **NAIL**.”



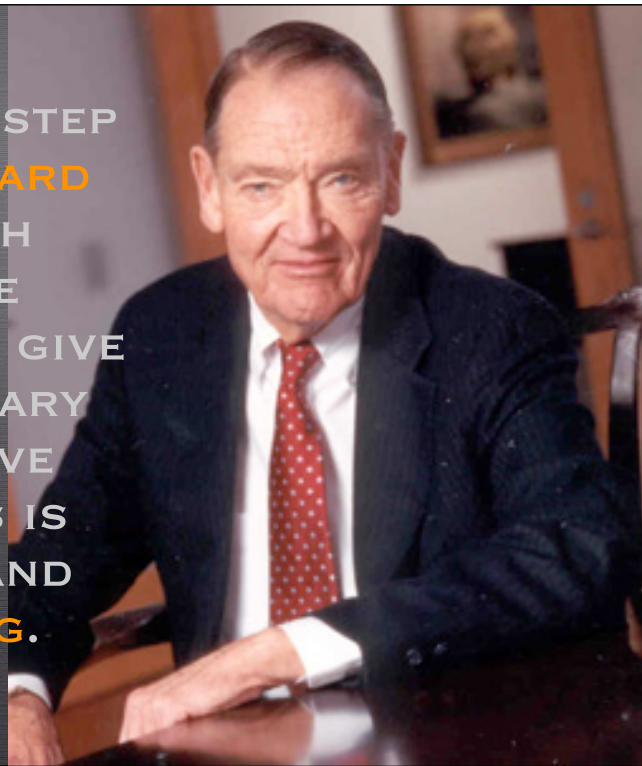
“THE FIRST STEP
IS TO MEASURE
WHAT CAN BE
EASILY
MEASURED. THIS
IS OKAY AS FAR
AS IT GOES.

JOHN BOGLE

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“THE SECOND STEP
IS TO **DISREGARD**
THAT WHICH
CANNOT BE
MEASURED, OR GIVE
IT AN ARBITRARY
QUANTITATIVE
VALUE. THIS IS
ARTIFICIAL AND
MISLEADING.”



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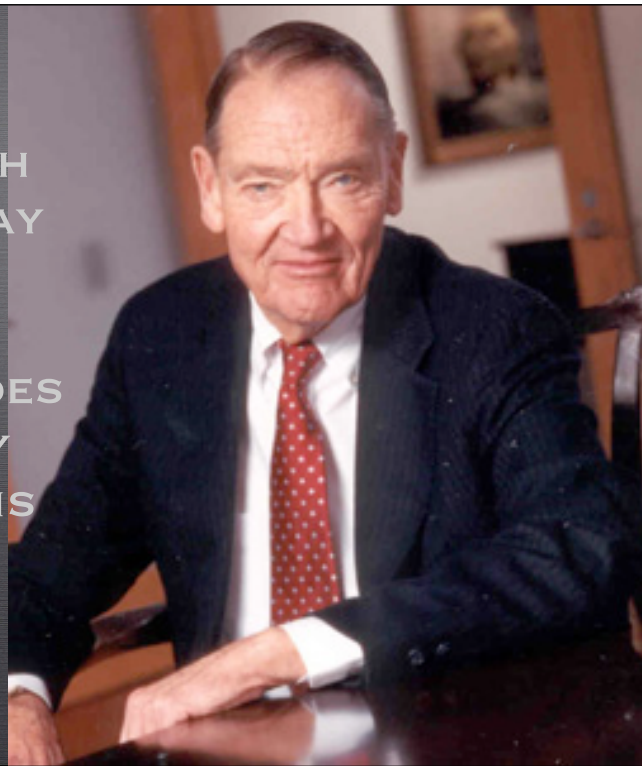


“THE THIRD
STEP IS TO
PRESUME
THAT WHAT
CANNOT BE
MEASURED
REALLY IS
NOT VERY
IMPORTANT.
THIS IS
BLINDNESS.

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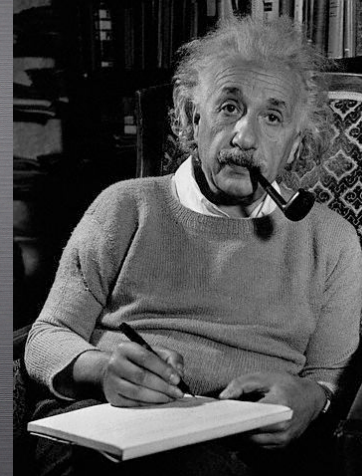
“THE FOURTH
STEP IS TO SAY
THAT WHAT
CANNOT BE
MEASURED DOES
NOT REALLY
EXIST. THIS IS
SUICIDE.”



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“NOT EVERYTHING
THAT COUNTS CAN
BE COUNTED, AND
NOT EVERYTHING
THAT CAN BE
COUNTED, COUNTS.”



ALBERT EINSTEIN

Example # II

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Beta does not capture risk

β



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But beta is easily calculated.

You will soon discover superinvestors like Warren Buffett discard precisely calculated beta as a measure of risk. Instead they use, rough but correct definition of risk.

Keynes said correctly: “Its better to **approximately** right than to be **precisely** wrong.”



“PEOPLE **CALCULATE** TOO MUCH AND
THINK TOO LITTLE.”

ANTIDOTES



LOOK FOR
DISCONFIRMING
EVIDENCE — KILLING
YOUR OWN IDEAS

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UNDER-WEIGH EXTRA-
VIVID EXPERIENCE AND
OVERWEIGH LESS VIVID
EXPERIENCE.



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Same with recent events; i.e. cool off period after meeting someone very impressive and impressionable.

“Sleep over it.”



“REMEMBER THE LESSON: “AN
IDEA OR A FACT IS NOT WORTH
MORE MERELY BECAUSE IT IS
EASILY AVAILABLE TO YOU.””

Thank you

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