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'THINKING, FAST AND SLOW' STRATEGY

TWO THOUGHT MODES FOR INVESTING

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NOBEL prize-winning economist Daniel Kahneman wrote the popular science book 'Thinking, Fast and Slow' in 2011.

The book's central thesis is a differentiation between two modes of thought: "System 1" is fast, instinctive and emotional; "System 2" is slower, more deliberative and more logical.

The book delineates rational and non-rational motivations or triggers associated with each type of thinking process and how they complement each other.

Applying Kahneman's 'Thinking, Fast and Slow' to stock investing involves understanding the two systems of thinking he describes and recognising their impact on decision-making.

These systems are crucial in stock investing in shaping our judgments and decisions.

System 1 and Stock Market Heuristics (Fast Thinking)

System 1 thinking relies on heuristics or mental shortcuts to quickly make decisions. In stock investing, this can lead to cognitive biases and errors.

For example, investors might rely on recent market trends (recency bias) or follow the crowd (herd mentality) without thoroughly analysing information. Recognising these biases is crucial to avoid making impulsive decisions driven by emotional reactions.

Investors should be aware of how System 1 thinking can influence their perception of stocks. Regularly questioning assumptions and being conscious of emotional responses can help mitigate the impact of these biases.

Often, the Fear of Missing Out (FOMO) pressures investors to make a hurried investment decision. Investors should bear in mind the age-old saying "decide in haste, repent at leisure".

System 2 and Analytical Thinking (Slow Thinking)

System 2 thinking involves deliberate and analytical reasoning. In stock investing, this corresponds to conducting thorough research, analysing financial statements and considering a company's long-term prospects.

This involves dedicating time to research and analysis. Investors should embrace a disciplined approach, thoroughly examining the fundamentals of a stock before making decisions. This includes assessing financial health, competitive positioning, and industry trends.

System 2 thinking is a counterbalance to the impulsive nature of System 1, promoting more thoughtful and reasoned investment choices.

Prospect Theory and Loss Aversion

Kahneman's prospect theory suggests that individuals weigh potential losses more heavily than equivalent gains. This is crucial in stock investing, where fear of losses can drive sub-optimal decisions.

Investors may be inclined to sell winning stocks too early to secure profits (loss aversion) or hold onto losing stocks in the hope of a rebound, even when the fundamentals suggest otherwise. Many investors will be able to relate to these phenomena.

Closely examining our portfolios may reveal stocks that are being held on the mere premise of hope — never a sound basis for fundamental investing.

Investors should be aware of their tendency towards loss aversion. Establishing clear investment goals, maintaining a diversified portfolio and setting stop-loss orders can help mitigate the impact of this bias.

System 2 thinking can be particularly useful in challenging the emotional responses associated with loss aversion, facilitating more rational decision-making. It helps mitigate the effects of fear and greed — the predominant emotions that are a scourge of many an investor.

Overconfidence and Anchoring

Overconfidence, another cognitive bias highlighted by Kahneman, can lead investors to overestimate their abilities and underestimate risks. Anchoring occurs when individuals rely too heavily on the first piece of information encountered when making decisions.

Both biases can significantly impact stock investing.

To address overconfidence and anchoring, investors should approach their decisions with humility and a healthy dose of scepticism.

Regularly reassessing investment theses and remaining open to new information can help overcome these biases. A systematic approach, such as setting specific criteria for stock selection and periodically reviewing investment decisions, can counteract the tendency to anchor on initial impressions.

Being faithful to a chosen investment methodology reduces the risks associated with overconfidence and anchoring substantially.

Time Horizon and Framing

Kahneman emphasises the importance of framing — how information is presented can influence decisions. In stock investing, considering the time horizon is crucial.

Short-term market fluctuations may induce emotional reactions while a longer-term perspective allows investors to focus on fundamental factors.

Applying 'Thinking, Fast and Slow' involves framing investment decisions in a way that aligns with one's financial goals and time horizon.

System 2 thinking plays a key role here, allowing investors to step back and assess the bigger picture rather than reacting impulsively to short-term market movements.

Investors tend to be fixated on stock price movements when nothing has fundamentally changed about the company.

Price volatility without a basis has been likened to noise that can eventually become deafening. It urges and pressures an investor to act when the better alternative would have been to step back, away from the noise, and ask the pertinent question — has anything fundamentally changed about the company to warrant the price change?

Conclusion

Applying Kahneman's 'Thinking, Fast and Slow' to stock investing requires a nuanced understanding of the interplay between System 1 and System 2 thinking.

By integrating these principles, investors can enhance their decision-making process and navigate the complexities of the stock market with greater resilience and success.

The writer is chief executive officer of Minority Shareholders Watch Group.