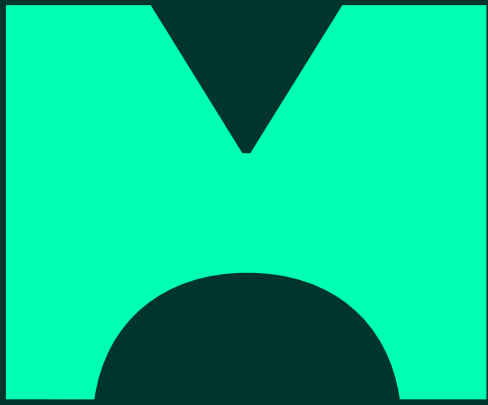




The investors blind spots.

A field guide to behavioural
bias in equity investing.

Seventeen Meditations



Shared conviction *without* the noise.

Merlon

FOREWORD

A note to the reader.

Over decades in this business, we have come to believe that the investor's most valuable instrument is not a spreadsheet or a terminal or even a well-stocked network of contacts. It is a mirror.

Markets are, in the end, a mechanism for aggregating human psychology into prices. And human psychology, it turns out, is systematically biased in ways that an attentive observer can identify — first in others, and then, with some humility, in oneself.

What follows is not a catalogue of exotic pathologies. It is a map of the territory we all inhabit. Every bias described in these pages is one we at Merlon Capital has, at some point, walked directly into. The goal is not to be free of these biases. That goal is not available to us. The goal is to know them well enough to recognise their footprints when we find ourselves in territory we thought we understood.

Daniel Kahneman — who did more than anyone to put this field on a rigorous foundation — was once asked which of the biases he had written about still tricked him most easily. His answer was, in effect, all of them. If the man who named the phenomenon cannot inoculate himself against it, we should not pretend we can.

What we can do is build processes, cultivate doubts, and surround ourselves with colleagues who will disagree with us honestly. We can read books like this one — not to earn a feeling of mastery, but to be reminded of how much we do not master.

Markets humble the overconfident. They punish the emotional. They reward the second-level thinker who can see what the crowd cannot. The crowd, most of the time, is looking directly at itself — and not knowing it.



BIAS NO. 01

Loss Aversion

"Loss aversion refers to the fact that people react differently between potential losses and potential gains."

— Daniel Kahneman

"Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks."

— Warren Buffett



THE BIAS

We do not weigh gains and losses on the same set of scales. The pain of losing a dollar bites roughly twice as hard as the pleasure of finding one. This is not a character flaw. It is the wiring we inherited from ancestors for whom a single missed meal could mean death. But what served the hunter-gatherer punishes the investor.

THE EVIDENCE

Kahneman and Tversky's 1979 paper on prospect theory — work that would eventually earn Kahneman the Nobel Prize — established that losses loom between two and two-and-a-half times larger than equivalent gains in our subjective experience. The finding has been replicated across cultures, asset classes, and decades.

IN EVERYDAY LIFE

Think of the last concert ticket you bought. The day of the show arrives and, as it happens, so does a head cold. You would have happily skipped a free performance in the same weather. But you had paid for this one. So you went, miserable, because not going felt like losing. Your evening was being punished by an accountant in your own head.

THE TAKEAWAY

The investor who cannot tolerate small losses will, sooner or later, hold onto large ones. The willingness to be wrong quickly is not a weakness. It is one of the few durable edges available to us.



BIAS NO. 02

Confirmation Bias

"What the human being is best at doing is interpreting all new information so that their prior conclusions remain intact."

— Warren Buffett

"Any fool can know. The point is to understand."

— Albert Einstein



THE BIAS

Once we have taken a view, we become more interested in being right than in being correct. We seek out the information that confirms us, discount the information that would unseat us, and, most dangerous of all, simply fail to notice the evidence we were not looking for. The market does not care whether our thesis is pleasing. It cares only whether it is true.

THE EVIDENCE

Peter Wason's famous 2-4-6 task showed subjects would rather prove their initial theory than test it. Given the freedom to generate any sequence they liked and be told whether it fitted a hidden rule, few subjects generated sequences designed to disprove their hypothesis. Most generated confirmations, gathered a tidy pile of them, and walked away confidently wrong.

IN EVERYDAY LIFE

After you have bought a car — say, a navy-blue sedan — you begin to notice navy-blue sedans everywhere. They were there all along. You were not.

THE TAKEAWAY

After you have committed to a thesis, your most valuable asset is the colleague who disagrees with you. If everyone in the room is nodding, someone has stopped thinking.



BIAS NO. 03

Anchoring

"The price you pay for a bond or a security determines its rate of return — and there can be nothing more fundamental than that."

— John Templeton

"Anchoring occurs when people consider a particular value for an unknown quantity before estimating that quantity."

— Daniel Kahneman



THE BIAS

Faced with uncertainty, the mind reaches for the nearest number — no matter how arbitrary — and drags its estimate toward it. The first price you see, the price you paid, the fifty-two-week high: each of these becomes a ghost that haunts your subsequent judgement, regardless of whether it has any bearing on the question in front of you.

THE EVIDENCE

In Kahneman and Tversky's classic experiment, subjects watched a wheel of fortune spin to what they were told was a random number, then were asked what percentage of UN members were African nations. Those whose wheel stopped at 10 estimated around 25 per cent. Those whose wheel stopped at 65 estimated around 45 per cent. The wheel had nothing to do with the UN. It did not matter.

IN EVERYDAY LIFE

The sticker on the jumper says "Was \$200 — Now \$99." You feel you are being handed a gift. But \$99 is only a bargain relative to a number you just saw thirty seconds ago and have no reason to trust.

THE TAKEAWAY

The price you paid for a stock is not a fact about the stock. It is a fact about your autobiography. The two should not be confused.

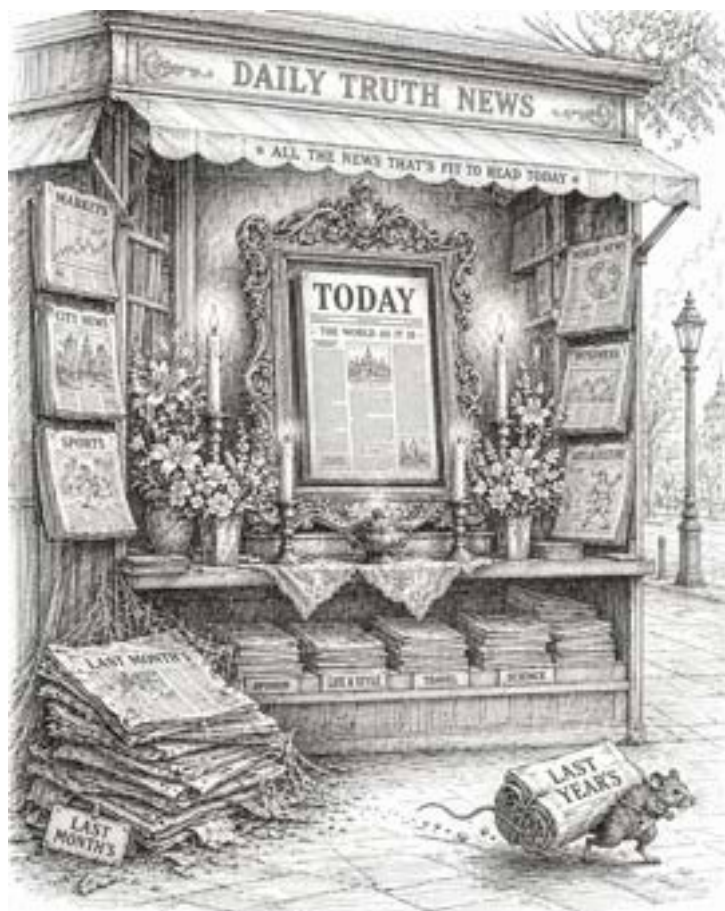


BIAS NO. 04

Availability Bias

"It is the mark of a truly intelligent person to be moved by statistics."
— George Bernard Shaw

"There are known knowns, known unknowns, and unknown unknowns."
— Donald Rumsfeld



THE BIAS

We judge the probability of events by how easily we can call examples to mind. Vivid, recent, emotional, newsworthy — the things we can picture feel more likely than the things we cannot. It is a useful shortcut for a creature that had to estimate, on the savannah, whether there were many lions nearby. It is a disaster for a creature trying to estimate the risk in a portfolio.

THE EVIDENCE

A Cornell University study published in 2001 found that companies with the highest press coverage in a given year went on to underperform in each of the following two years. The spotlight, it turns out, is not free; someone pays for it in their returns. Behavioural researchers have documented the same pattern after plane crashes, shark attacks, and market panics.

IN EVERYDAY LIFE

You would never volunteer for a shark cage, but you would happily swim at the same beach on holiday. Sharks kill roughly five people globally per year. Cows kill around twenty Americans. But a cow has never starred in a summer film.

THE TAKEAWAY

The stocks that dominate the front page are rarely the ones that will quietly reward you. Ask not what is most vivid, but what is most probable.



BIAS NO. 05

Overconfidence

*"It ain't what you don't know that gets you into trouble.
It's what you know for sure that just ain't so."
— Mark Twain (attributed)*

*"Confidence is what you have before you understand the problem."
— Woody Allen*



THE BIAS

Most of us, most of the time, believe we are better than most. This is, by definition, impossible. And yet the belief persists — stubbornly, universally, and at every level of experience and credential. Overconfidence leads us to overstate what we know and understate what can go wrong. In investing, the second error is usually the expensive one.

THE EVIDENCE

More than ninety per cent of drivers rate themselves as above-average. In a landmark 2000 study of nearly sixty-six thousand retail brokerage accounts, Brad Barber and Terrance Odean found that the most active traders — those presumably most confident in their abilities — underperformed the market by roughly 6.5 percentage points per year. Trading, in their phrase, was hazardous to their wealth.

IN EVERYDAY LIFE

Ask a hundred strangers to rate their own sense of humour on a scale of one to ten. Almost none will say four. Mathematically, at least half must be wrong.

THE TAKEAWAY

Someone once said: aim for timid forecasts and bold choices. I cannot improve on that. Underestimate what you know. Overestimate what can go wrong. And then act, once, with conviction.



BIAS NO. 06

Herding

"Be fearful when others are greedy, and be greedy when others are fearful."
— Warren Buffett

*"Bull markets are born on pessimism, grow on scepticism,
mature on optimism, and die on euphoria."*
— John Templeton



THE BIAS

When we are uncertain about what is true, we look to others for clues. This was adaptive on the plains, where the herd running from an unseen sound was safer than the lone sceptic who stayed to investigate. In markets, it is lethal. The crowd is, almost by definition, buying at the top and selling at the bottom — because those are the moments when the crowd is most certain.

THE EVIDENCE

Solomon Asch's 1951 conformity experiments confronted subjects with a simple visual question to which the obvious answer was placed in conflict with the unanimous, confident, and wrong answer of a group of confederates. Three in four subjects conformed to the group's error at least once. At the scale of the market, this is how bubbles form — and how they end.

IN EVERYDAY LIFE

Two restaurants open side by side on a quiet street. One has a line out the door; the other is empty. You join the line. You do not ask what is on the menu.

THE TAKEAWAY

You cannot do what the crowd does and expect a different result from the crowd. Which means: most of the time, you will feel uncomfortable. Discomfort is not evidence of error. It is often evidence of opportunity.



BIAS NO. 07

Hindsight Bias

"History is what you remember. The past is what actually happened."

— Anonymous

"We have a tendency to see the past as more predictable than it actually was."

— Daniel Kahneman



THE BIAS

After events unfold, we convince ourselves that we saw them coming. The genuinely uncertain past rewrites itself in memory as inevitable. This is why every crash is explained, in retrospect, by commentators who were writing something quite different the week before. And it is why we learn far less from experience than we like to believe.

THE EVIDENCE

Baruch Fischhoff's landmark studies in the early 1970s asked subjects to assess the probability of various outcomes before events, and then to recall their own assessments after learning what happened. Consistently, subjects remembered having assigned higher probabilities to the actual outcome than they had. The past, in memory, is always more predictable than the future.

IN EVERYDAY LIFE

You watch a film for the first time. Halfway through, someone spoils the twist. For the rest of the film, you can see nothing but the clues that led to it. "It was obvious," you think. It was not obvious five minutes ago.

THE TAKEAWAY

If everyone saw it coming, nobody did. Keep a journal of your forecasts, date them, and read them back in a year. You will be humbled. Humility is the beginning of improvement.



BIAS NO. 08

(Narrow) Framing

"A problem well stated is a problem half solved."
— Charles Kettering

"Risk comes from not knowing what you're doing."
— Warren Buffett



THE BIAS

The same fact changes our decision depending on how it is presented. We do not evaluate reality; we evaluate descriptions of reality. This matters enormously in investing, where every earnings call, every prospectus, every research report is a frame chosen by someone whose interests may not coincide with our own.

THE EVIDENCE

Tversky and Kahneman's 1981 "Asian disease problem" offered subjects two public-health programmes in response to an outbreak expected to kill 600 people. Frame A described outcomes in terms of lives saved; Frame B described the same outcomes in terms of lives lost. The underlying arithmetic was identical. Most subjects chose the "safe" option under Frame A and the "risky" option under Frame B — which were, in fact, the same option.

IN EVERYDAY LIFE

A label reading "95% fat free" sells meat at a premium over a label reading "contains 5% fat." Both labels describe the same piece of meat. Both are, technically, true.

THE TAKEAWAY

Before you accept the question someone has put to you, restate it. Then restate it again, the opposite way. If your answer changes, the frame was doing the thinking.



BIAS NO. 09

The Disposition Effect

"One of the best rules anybody can learn about investing is to do nothing, absolutely nothing, unless there is something to do."

— Jim Rogers

"Selling your winners and holding your losers is like cutting the flowers and watering the weeds."

— Peter Lynch



THE BIAS

Investors sell their winners too early and hold their losers too long.

Emotionally, it is far easier to lock in a gain — to claim, to oneself, a small victory — than to acknowledge, by selling, that one has made a mistake.

The result is a portfolio that looks like a garden where the gardener has pulled up the flourishing plants and is carefully watering the dying ones.

THE EVIDENCE

In 1998, Terrance Odean examined roughly ten thousand accounts at a large discount brokerage. He found that investors sold their winning stocks at a rate fifty per cent higher than their losers. More remarkably, the winners they sold went on to outperform, in the following year, the losers they kept. The emotional logic was exactly the reverse of the financial logic.

IN EVERYDAY LIFE

Imagine keeping two plants on your windowsill. One is thriving; the other is browning at the edges. You prune the thriving one aggressively — “before it gets too big” — and pour every drop of water into the dying one, because surely it is due.

THE TAKEAWAY

Your portfolio has no memory of what you paid for each position. Neither should your decisions. The only question that matters is: does this deserve a seat in the portfolio today?



BIAS NO. 10

The Endowment Effect

"People are strange: they are constantly angered by trivial things, but on a major matter like wasting their lives, they hardly seem to notice."

— Charles Bukowski

"The pain of giving up a bottle of nice wine is greater than the pleasure of getting one."

— Richard Thaler



THE BIAS

We value things more once we own them, regardless of what we would pay to acquire them. A stock in our portfolio feels meaningfully different from a stock on a watchlist — even though, mathematically, they are the same claim on the same cash flows. This is the difference between a position and a relationship.

THE EVIDENCE

Kahneman, Knetsch, and Thaler's 1990 experiments gave coffee mugs to half a group of randomly chosen subjects and asked them the price at which they would sell. The other half were asked what they would pay to buy the same mug. Owners demanded roughly twice what non-owners were willing to pay. The mugs were identical. Only the ownership was new.

IN EVERYDAY LIFE

The stock your father left you. He believed in the company. You believed in him. You cannot quite bring yourself to sell. The share price does not know any of this.

THE TAKEAWAY

Every morning, cast a clear eye on each of your holdings and ask: if I did not already own this, would I buy it today? The positions for which the honest answer is "no" deserve your attention first.

BIAS NO. 11

The Narrative Fallacy

"The narrative fallacy addresses our limited ability to look at sequences of facts without weaving an explanation into them."

— Nassim Nicholas Taleb



BIAS NO. 11 | THE NARRATIVE FALLACY

THE BIAS

The human mind does not store facts. It stores stories. When the facts of a case do not fit a clean narrative, we edit the facts — subtly, unconsciously — until they do. This is why great investments with great stories are often disappointing, and why great investments without any story at all are where the returns so often hide.

THE EVIDENCE

Taleb popularised the term in *The Black Swan*, but the underlying phenomenon has been documented since Frederic Bartlett's 1932 memory studies, which showed that people re-shape ambiguous information into coherent, culturally familiar narratives over time. Each retelling is a further step away from the evidence and closer to the shape of a good story.

IN EVERYDAY LIFE

After any significant market decline, the financial press explains, with great confidence and considerable detail, exactly why it happened. Before the decline, the same press predicted no such thing.

THE TAKEAWAY

Be wary of the stock that arrives with a beautiful story. The better the story, the more of its expected future the price has already absorbed. Where there is no story yet — that is sometimes where the opportunity lives.



BIAS NO. 12

The Sunk Cost Fallacy

"In for a penny, in for a pound."
— English proverb

"You must never confuse what a company is worth with what it cost you."
— Benjamin Graham



THE BIAS

The money you have already spent — or lost — should have no bearing on the decision in front of you. It does, routinely, bear on that decision. We throw good capital after bad, sit through bad films because the ticket was costly, and, worst of all, add to losing positions because the position itself has become our identity.

THE EVIDENCE

Arkes and Blumer's 1985 study sold theatre-season tickets at three different prices — full, thirteen per cent off, and forty-seven per cent off — to otherwise similar subjects. Those who had paid full price attended more plays over the season, though the plays were the same. Having paid more, they felt compelled to extract more. Their evenings were being punished by their own receipts.

IN EVERYDAY LIFE

You are an hour into a film you already know is bad. The correct course of action — to leave — costs you nothing further. You stay. Your time is now being punished for your money's earlier mistake.

THE TAKEAWAY

The best question about any investment is not "what did I pay for it?" but "what would I pay for it today, knowing what I know now?" If the answer is nothing, the next step writes itself.



BIAS NO. 13

The Illusion of Control

"The market can remain irrational longer than you can remain solvent."
— John Maynard Keynes (attributed)

"You don't get to choose the outcomes. You get to choose the bets."
—Annie Duke



THE BIAS

We overestimate our influence over outcomes that are substantially governed by chance. This bias is particularly dangerous in investing because we are surrounded by screens, charts, tools, and buttons — all of which give us the physical sensation of being in control. The market, for its part, does not know we are watching.

THE EVIDENCE

Ellen Langer's 1975 studies found that subjects would pay more for a lottery ticket they had chosen themselves than for a ticket handed to them at random. The probability of winning, of course, was identical. The sense of agency, however, commanded a premium.

IN EVERYDAY LIFE

The gambler who blows on the dice. The passenger who taps an imaginary brake when the driver is going too fast. The day trader who closes a losing position "before it gets worse", convinced the act of closing it changes the market.

THE TAKEAWAY

Process you can control. Outcomes you cannot. Confusing the two — crediting yourself for good luck, blaming the world for bad — is the fastest way to learn nothing at all.



BIAS NO. 14

Regret Aversion

"Twenty years from now you will be more disappointed by the things you didn't do than by the ones you did."

— Attributed to Mark Twain

"I have not failed. I've just found 10,000 ways that won't work."

— Attributed to Thomas Edison

"You miss 100% of the shots you don't take."

— Wayne Gretzky



THE BIAS

The fear of regretting a decision can prevent us from making any decision at all. The errors of commission — the things we did and wish we had not — haunt us more vividly than the errors of omission. And so we do not buy when we should; we do not sell when we should; and we comfort ourselves that inaction is safer than action. It is not. It is merely quieter.

THE EVIDENCE

Loomes and Sugden's 1982 regret theory formalised the finding that anticipated regret systematically distorts choices away from expected-value maximisation. Subjects consistently prefer options that minimise the possibility of future self-reproach, even when doing so lowers their expected return.

IN EVERYDAY LIFE

You pass up an investment because the friend who suggested it will gloat unbearably if it works. The investment works. Your portfolio and your friendship both quietly suffer.

THE TAKEAWAY

Inaction is a decision too. It just feels like less of one. The best investors make peace early with the fact that they will, on some number of days each year, look foolish. And then they act anyway.



BIAS NO. 15

Base Rate Neglect

"In God we trust. All others must bring data."
— W. Edwards Deming

*"Most of what we call intelligence comes down to
avoiding especially stupid mistakes."*
— Charlie Munger



THE BIAS

We focus on the vivid details of the case in front of us and ignore the underlying statistical frequencies that govern outcomes. The friend's cousin who made a fortune on the penny stock is a story. The ninety-nine other cousins who lost money on penny stocks are a statistic. Stories move us. Statistics do not.

THE EVIDENCE

Kahneman and Tversky's 1972 taxicab problem asks: a hit-and-run occurs at night. Eighty-five per cent of the cabs in the city are Green, fifteen per cent Blue. A witness identifies the cab as Blue, and is shown to be eighty per cent accurate in such conditions. Most people, asked the probability that the cab was in fact Blue, answer eighty per cent. The correct answer, by Bayes' theorem, is forty-one per cent. The base rate matters enormously. We almost never consult it.

IN EVERYDAY LIFE

"My cousin put ten thousand dollars into this little mining company and it went up ten times." The cousins you hear about are always the ones it worked for. The silent cousins paid for their stories.

THE TAKEAWAY

The right question is rarely "could this work?" The answer to that is almost always yes. The right question is: "how often does this kind of thing work — and at what cost when it doesn't?"



BIAS NO. 16

Motivated Reasoning

"It is difficult to get a man to understand something when his salary depends upon his not understanding it."
— Upton Sinclair



THE BIAS

We do not, as we like to imagine, gather evidence and then form a conclusion. More often we begin with a conclusion that suits us — emotionally, financially, professionally — and then assemble the evidence in its defence. The reasoning is real; it can be elaborate, even brilliant. What is missing is impartiality. The mind has been hired by the conclusion before the work begins.

THE EVIDENCE

Ziva Kunda's landmark 1990 review in *Psychological Bulletin* synthesised two decades of experimental work showing that people evaluate the same evidence differently depending on what they wish to be true. In a representative study, participants asked to read research linking caffeine to a serious health condition were markedly more sceptical of the methodology when they themselves were heavy coffee drinkers. The evidence was identical. The evaluators were not.

IN EVERYDAY LIFE

Two analysts read the same earnings report. One owns the stock; the other is short it. Each will tell you, sincerely, that they are reading the numbers honestly. Each will reach the conclusion their position required them to reach.

THE TAKEAWAY

Before you trust a conclusion — your own most of all — ask what the person reaching it stands to gain by reaching it. If the answer is anything other than nothing, raise the bar for the evidence accordingly.



BIAS NO. 17

Attribution Bias

*"Don't confuse brains with a bull market."
— Humphrey B. Neill*



THE BIAS

When things go well, we credit our skill. When things go badly, we blame the weather, the market, the unfair playing field. This asymmetry is not occasional; it is structural. We are the heroes of our successes and the victims of our failures. The result is an investor who learns very little from a long career, because every outcome has been pre-sorted into the file labelled "as expected."

THE EVIDENCE

Edward Jones and Richard Nisbett's 1971 work on the actor–observer asymmetry, and the broader self-serving bias literature that followed, established that people consistently attribute their successes to internal factors (talent, judgement) and their failures to external ones (luck, circumstance) — while reversing the pattern when judging others. Studies of fund managers' letters to clients have repeatedly found exactly this asymmetry in print: gains explained by stock selection, losses explained by macro headwinds.

IN EVERYDAY LIFE

The investor who buys a stock that triples calls it "good research." The investor who buys a stock that halves calls it "an unforeseeable shock." The two investors are often the same person, in the same year.

THE TAKEAWAY

Process and outcome are different things, and luck is a frequent guest at both tables. The investor who can honestly distinguish a good decision from a good result — and a bad decision from a bad result — owns one of the rarest assets in this business.



Shared conviction *without* the noise.

Merlon

FURTHER READING

A starter library.

The habits of thought sketched in these pages have been the subject of wiser and more rigorous work by many others. What follows is not a canon; it is a shelf. Begin wherever curiosity pulls you.

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AFTERWORD

A final word.

Seventeen biases. There are, of course, many more. The field continues to grow, and anyone serious about this work should read Kahneman, and Thaler, and Shiller, and Taleb, and argue with all of them. What matters is not that you master the taxonomy. What matters is that you recognise yourself in it.

The discouraging truth about behavioural bias is that knowing about it does not, by itself, cure it. We can read every paper ever written on overconfidence and still be overconfident tomorrow morning. We are not built to think clearly under uncertainty. We are built to survive.

The encouraging truth is that the market does not require us to be perfectly rational. It requires us only to be somewhat less irrational than the person on the other side of the trade. That is a meaningfully lower bar, and it can be cleared — not by becoming a different kind of person, but by building habits, processes, and relationships that catch us at the moments when we are most reliably ourselves.

Second-level thinking is not a trick. It is an attitude. It asks us to step out of the crowd, which is uncomfortable, and then, some of the time, to step back into it, which is harder still.

The market is an instrument of considerable cruelty and, for the patient, considerable reward. It punishes the things we cannot help doing, and pays for the things we have to learn.

Good luck. You will need it. You will also need less of it than you think.



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