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We Are Not Odysseus

‘The Siren Vase’, c.480-470BC, Attica, Greece

The epic hero Odysseus and the Behavioural approach to finance both seek to obtain knowledge by overcoming emotion with reason. But in ignoring the emotional component of decision-making, we turn our backs on the power of intuition. Intuitive thinking, when properly developed, can be far more powerful than analytical thinking. But knowing when to trust your gut is difficult, and getting it wrong can do more harm than good. So how do you distinguish valuable intuitions from misleading biases? We propose three approaches: emotions as data, psychoanalytic, and meditation. Furthermore, how do you incorporate intuition into a robust and repeatable investment process? We believe that the 'learning system' we use at *Cape Wrath Capital* offers a solution.

We Are Not Odysseus

Odysseus, the legendary King of Ithaca, enjoyed a good life hack. Sailing home from the Trojan War, he was keen to hear the enchanting song of the Sirens, but equally determined to avoid the shipwreck and death which was the fate of every other sailor who had done so. His solution was to have the crew tie him to the mast and plug their own ears with beeswax. Once in earshot, the more Odysseus begged to be untied, the tighter the crew bound him.[1] For achieving knowledge by subjugating emotion to reason, Odysseus is a poster boy for the Behavioural approach to finance.

Behavioural finance starts with the premise that our brains did not evolve to make investment decisions, or trade financial markets. When faced with stress and uncertainty, we default to the mental shortcuts that served us well as cavemen. If the tribe suddenly takes off in a certain direction, best not to wait around and ask too many questions (we value investors refers to this as the ‘momentum effect’, particularly during periods of underperformance). Beyond these heuristics, the Behavioural approach is also concerned with the tricks we play to protect the ego. Confirmation bias, self-attribution and regret aversion all help to preserve our sense of self-worth, even at the expense of our net worth.

The Behavioural solution to the problem of ego and heuristics is to be more like Odysseus. Subjugate emotion to reason, create a rules-based process, tie yourself to the mast and enjoy the alpha denied to those who heed the siren’s call. But achieving self-knowledge by overcoming emotion with reason is like throwing the baby out with the bathwater. The standard Behavioural interpretation misses the point.

[1] The Sirens were one of many trials and temptations that befell Odysseus (also known as Ulysses) on his way home from the Trojan War, as told in Homer’s epic poem ‘The Odyssey’. The Sirens were monsters disguised as beautiful women who used their wonderful melodies to lure sailors to certain death. Warned of this by the Goddess Circe, Odysseus told his crew to row past the Sirens’ island and gave each man a block of wax to plug his ears. Determined to hear the Siren’s song himself, Odysseus did not plug his own ears, but instead had his crew bind him to the mast. When he heard the Sirens’ song, Odysseus was so enchanted that he wanted to dive into the sea and swim to the island. He strained so hard at his bonds that they cut him, and he begged the crew to untie him. Having been warned by Odysseus that this would be his reaction, the crew rowed harder, only stopping when they were safely past the island.

In fact, to be better investors we need to be less King of Ithaca and more Fire Chief. In the 1970s Gary Klein studied real-world decision-making under uncertainty, and in particular the role of expert intuition. His work crossed-over with that of Daniel Kahneman, with whom he jointly published. For me, the hero of Klein's work is the Fire Chief, who pulled his team out of the kitchen fire that they were tackling just moments before the kitchen collapsed into the basement. The Fire Chief couldn't initially explain why he had made the decision, which had saved the lives of his team.[1] It turned out that the heart of the fire was not in the kitchen, as they had supposed, but in the basement below where they had been standing.

The value of intuition, or unconscious pattern recognition,[2] is the value of raw calculating power. The unconscious mind processes about 20 million bits of information in one second. During that time the conscious mind can processes about 40 bits. That's a 500,000x difference. The Behaviouralists argue for eliminating your biases and using your reason. They think the big win comes from using your abacus more effectively. We believe you should acknowledge your biases and harness your intuition. We think the big win comes from ditching the abacus and learning how to use your supercomputer.

But getting it wrong can do more harm than good, and at the conscious level those valuable intuitions manifest themselves as an emotional response, apparently indistinguishable from treacherous heuristics and ego defence mechanisms. So, how does the conscious mind know the difference between the Fire Chief and the Caveman? In other words, when should you trust your gut?[3]

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[1] The Fire Chief later reflected that the fire had seemed unusually quiet and his ears had been unusually hot. His intuition was that something was wrong, although at the time he didn't know what.

[2] The late, great, Herbert Simon studied chess masters and found that there was no 'magic' in intuition, rather, 'The situation has provided a cue; this cue has given the expert access to information stored in memory, and the information provides the answer. Intuition is nothing more and nothing less than pattern recognition.' (Simon, H. 'What Is an Explanation of Behaviour?', Psychological Science 3, 1992, p.150-61)

[3] Kahneman provides a scathing assessment of the use of 'intuition' in our own profession; 'Many years ago I visited the Chief Investment Officer of a large financial firm, who told me that he had just invested some tens of millions of dollars in the stock of Ford Motor Company. When I asked how he had made that decision, he replied that he had recently attended an automobile show and been impressed. "Boy do they know how to make a car!" was his explanation… I found it remarkable that he had apparently not considered the one question that an economist would call relevant: Is Ford stock currently underpriced? Instead, he listened to his intuition; he liked the cars, he liked the company, and he liked the idea of owning its stock. From what we know about the accuracy of stock picking, it is reasonable to believe that he did not know what he was doing.' (Kahneman, D. 'Thinking Fast and Slow', Penguin Books, London, 2012, p.12)

We believe that there are three inter-related approaches.

The first approach is the 'left-brain / right-brain' (Voss), or 'emotions as data' (Shull) school, which treats our emotions and instinctive responses (be they the product of intuition or heuristics) as inputs into the analytical process.[1] This requires us to be tuned-in to our emotions, and stresses the importance of making decisions under uncertainty only when our energy levels and emotional state are optimal. Typically, we create the link between our unconscious awareness and conscious attention by articulating our emotions. This approach ties-in with our own use of empathy at *Cape Wrath Capital* to assess the sentiment around a stock, which feeds into the narrative we build to explain the current market valuation.

The second approach is psychoanalytic. To quote Norman Dixon, 'Man is basically… a dark cellar in which a well-bred spinster lady and a sex-crazed monkey are forever engaged in mortal combat, the struggle being refereed by a rather nervous bank clerk.' Whether we succeed or fail, in investing or in life, depends on how this struggle resolves. The therapist's toolkit, replete with Freudian theories like transference and repetition (where every situation is an opportunity to re-live the emotions of a formative experience),[2] signposts the bias in our decision-making. Putting our own investment process on the couch, the therapist would be interested to learn that we begin by finding companies that are 'hated' by the market. Our premise is that sometimes the market is wrong. In this value investor, perhaps in every value investor, is the child who lives for that moment when the adult says, 'I was wrong and you were right.'

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[1] This approach is linked to Kahneman's distinction between System 1, which is an automatic response mechanism and System 2, which is an analytical or controlled response mechanism. These Systems are sometimes discussed in connection with the amygdala (automatic) and prefrontal cortex (controlled) respectively. Although simplifications, these distinctions can be useful explanatory tools.

[2] LaPlanche and Pontalis describe the repetition compulsion as '… an ungovernable process originating in the unconscious. As a result of its action, the subject deliberately places himself in distressing situations, thereby repeating an old experience, but he does not recall this prototype; on the contrary, he has the strong impression that the situation is fully determined by the circumstances of the moment. These patterns acquired in childhood are forgotten and are instead acted out and repeated in life.' (LaPlanche, J. & Pontalis, J. 'The Language of Psychoanalysis', Hogarth Press, London, 1973)

The third approach comes from meditation, which can support decision-making in three ways. Meditation provides an emotional still-point, a stable platform for consistent decision-making; it provides a basis for studying emotions objectively; and it creates a link between our conscious and unconscious. For example, Transcendental Meditation ('TM'), visualises conscious thought as a bubble emerging on the surface of a lake. The practice of TM brings the mind, metaphorically, down to the bottom of the lake to witness the thought / bubble forming at its unconscious inception. TM, therefore, provides the possibility of clearly distinguishing useful intuitions from troublesome heuristics by observing them before they metamorphise into 'homogenous' emotions.[1]

But even if we find a way of developing our intuition, how can its benefits be measured and incorporated into a repeatable process? The key is to operate in an environment where you have access to consistent and accurate feedback. At *Cape Wrath Capital*, we call this environment our 'learning system', and it is based on three things. Firstly, we have an investment process that ensures our decisions are consistent. This provides a baseline against which measurements can be taken. Secondly, we have a set of tools for collecting and analysing the outcome of those decisions. Thirdly, we have an organisational culture with no sacred cows. If you're committed to improving things, you need to be prepared to take a hammer to everything you've ever built, because respecting your own legacy will only hold you back.

If we had solved the puzzle of intuition then you wouldn't be reading this Broadside, because we'd be too busy partying with Croesus to write it. Finding the answer helps us to understand not only how we should be as investors, but also how we are as people, and we believe that the destination will be as profitable as the journey has been enjoyable.

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[1] Ray Dalio, founder of Bridgewater Associates, has spoken and written widely about how TM improved his investment decision-making.

The Latticework

The ideas in this Broadside are largely taken from the following books:

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