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Overcoming Cognitive Biases: A Heuristic for Making Value Investing Decisions

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Abstract

Investment decisions are subject to error due to cognitive biases of the decision makers. One method for preventing cognitive biases from influencing decisions is to specify the algorithm for the decision in advance and to apply it dispassionately. Heuristics are useful practical tools for simplifying decision making in a complex environment due to uncertainty, limited information and bounded rationality. We develop a simple heuristic for making value investing decisions based on profitability, financial stability, susceptibility to bankruptcy, and margin of safety. This achieves two goals. First, it simplifies the decision making process without compromising quality, and second, it enables the decision maker to avoid potential cognitive bias problems.

Keywords:

Value investing | Margin of safety | Cognitive biases | Heuristics

Notes

1. p. 54 of Graham and Dodd [1934]; see also Graham [2006], p 3.

2. See a partial list under “Well-known Value Investors.” Retrieved from http://en.wikipedia.org/wiki/Value_investing

3. We would like to thank an anonymous reviewer for highlighting this aspect of Buffett-Munger value investing strategy.

4. See, for example, Athanassakos [2011], Chan and Lakonishok [2004], and Fama and French [1998].

5. O-S are the initials of the last names of the authors.

6. We recognize there is controversy in the psychology literature regarding heuristics perceived as a mental shortcut versus heuristics as an intuitive process using quick and associative processes to make judgments. We refer to heuristics as mental shortcut as the Gigerenzer school of thought (Gigerenzer [1996, 1997], Gigerenzer and Goldstein [1996]) and heuristics as an intuitive process as the Kahneman and Tversky school (Tversky and Kahneman [1974]). For purposes of this paper, we use the term “heuristics” in a generic sense to represent an informal, shorter, and faster approach to making decisions as opposed to a formal logical process that conforms to the norms of statistical inference.

7. See, for example, Pompian [2012], where more than 20 biases are listed, or Baron [2008] with over 50 biases listed.

8. See Thaler [1985], Benartzi and Thaler [1995].

9. See, for example, chapter 16 of Montier [2010].

10. See for example, James Montier. The Little Book of Behavioral Investing: How Not To Be Your Own Worst Enemy, New York: Wiley & Sons, 2010, p. 210; Dan Ariely. Predictably Irrational: The Hidden Forces that Shape Our Decisions, New York: HarperCollins Publishers, 2008, Ch. 9. A systematic critical analysis of the writings,

speeches, and interviews of Warren Buffett will show that this is what he does; but that is the subject of another paper.

11. Chairman's letter tow the Shareholders of Berkshire Hathaway Inc., 1992, http://www.berkshirehathaway.com/letters/1992.html.

12. Chairman's letter to the Shareholders of Berkshire Hathaway Inc., 1992, http://www.berkshirehathaway.com/letters/1992.html.

13. Note that intrinsic value is an approximation, not a precise number.

14. We believe professionals who understand the logic of the heuristic can easily adapt it for use with small cap companies.

15. By earnings stability, we do not mean earnings smoothing rather earnings predictability as ascertained by a history of stable earnings.

16. Based on the fact that nominal U.S. stock returns averaged between 9% and 12% (7% real return) over a 200-year period. See, for example, Siegel [2002], especially chapters 2 and 12. 15% is also the rate of growth of book value that Warren Buffett has set as benchmark for Berkshire Hathaway.

17. This is in line with our estimate of long-term GDP growth rate. In the long-run (after the company has exhausted its competitive advantage), it will only grow at the rate of growth of GDP). 3% is the average steady state rate of growth of GDP for G-8 countries. According to the Bureau of Economic Analysis, historically, from 1947 until 2012, the U.S. GDP growth rate averaged 3.23%, reaching an all-time high of 17.20% in March 1950 and a record low of negative 10.40% in March 1958.

18. See Piotroski [2000] and Altman [1968] on how these indices are calculated.

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