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## Mea Culpa

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Carol Tavris and Elliot Aronson describe in their delightful book *Mistakes Were Made, But Not by Me* how we humans struggle to come to terms with own mistakes. The principle behind refusing to recognize the beam in our own eye is a simple one of cognitive dissonance: "I see myself as a reasonable human being. I commit an act that no reasonable person would do. Therefore, it has to be someone else's fault". This book is easily an all time top five as it undresses our most fundamental mental pitfalls. Putting humble pie on the regular diet we can become better investors (life partners, parents, fellow human beings).

A more practical way to learn of our own mistakes is the game of chess. For us a little too keenly interested in the game the app Lichess is very useful. Besides constantly offering some 10,000 players in the lobby, the app has various tools to improve your game. As everyone knows, computers surpass humans at chess since about 20 years and the distance is growing. With streamed computer power Lichess makes it embarrassingly obvious what you and your opponent have missed in a recent match.

In chess, errors can be categorized according to their seriousness. In my interpretation, Lichess defines errors as deviations from the perfect game. Mistakes are more serious and can be seen as directly costly moves. Finally, there are blunders, which could be bluntly considered loss making moves.

Perhaps it takes a particularly twisted mind to roll around in the esthetics of failure, and it can take its toll on the ego. The worst part is winning a game and feeling you played well, then order a computer analysis and realizing the only reason for winning was that your opponent made more serious blunders than you.

However, without doubt there are benefits to looking down the abyss of failure. Taking the pain improves your game. In this context, the important question is if this masochistic narcissism is transferable to the investment world and if any practical utility can be gained. So let us use the chess taxonomy of failure and apply it on investments.

I would define investment errors as opportunity costs in some form. For instance, buying shares in company A, which appreciates 20 per cent per year, beating relevant comparisons by a margin, while forgetting to buy shares in company B, showing an even better performance. Or, it could be buying shares in a fantastic company the wrong week or month, a little too expensive, while seeing good returns over time. Another error might be neglecting to sell a stock when it is a tad too expensive, switching to something else and switching back perfectly six months later. If think we can all agree that we can live with these.

Let us define investment mistakes as something that would mean certain defeat against a clever opponent but no immediate disaster. It could be not taking enough risk, anxiously watching your benchmark from the closet. A kind of process error forming a mistake.

In my experience as coach and instructor in youth sports I can find many examples showing the importance of separating process and results. Unless children (and portfolio managers) feel some kind of basic comfort or security, for instance if team mates mock those making a technical error (or if some middle manager indicates portfolio manager expendability should they perform poorly in the next year), they will never dare to make any mistakes. And then they will never learn the skills necessary to master the situation. It is in the borderlands of your abilities you will find growth and progress. On the verge of failure, sometimes falling on the wrong side, we learn and develop.

With a process with enough room to play, mistakes will be more of the execution kind. So the first question to ask when you stare your own mistakes in the face should be: “did I follow my process?”. Looking back critically at my own behavior as an investor perhaps 80 per cent of all mistakes were due to a lack of discipline. To be carried away by a “story”, not doing my homework, excessive trust in others or making decisions without the necessary mental bandwidth.

As long as we are talking about mistakes, and not blunders, on some level this is all in order, on the condition that we learn and bring this knowledge with us in the future. Mistakes will be made, so why not accept them and love them, in the effort of strengthening your process as well as other good behaviors?

Blunders in the investment world are very similar to mistakes, only with a crucial difference in magnitude. Every investment almanack will include some version of “avoid bombs in the portfolio”. Using stop-losses might be one way to avoid mistakes growing into blunders. However, this technique probably finds its best use in a short term trading portfolio.

Personally, I am more inclined to use position sizing based on an assessment of financial risk associated with the individual stock. Thereby I can hopefully skew probabilities toward mistakes rather than blunders. This can be combined with what I would shortly describe as fundamental stop-losses, simply being ready to change opinion when facts change. In concrete terms this means I would rather sell a stock if it turns out the business model is not sustainable, not if the stock with a business model that has no best before-date (temporarily) becomes a little too expensive.



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