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DEEP RESEARCH FUND – INSIGHT

Dealing With Mistakes

In this report we would like to elaborate on how we deal with mistakes, how we recognize them and how we create a culture in which we can learn from past mistakes.

Mistake or misfortune?
Investing in stocks comes with neither certainty nor any guarantee of reaching individual investment goals. Dealing with ambiguity, an uncertain future and probabilities is part of any investor's daily grind. Since the basis for decision-making is often incomplete and includes assumptions and estimates, even the most sophisticated investment approach cannot eliminate occasional losses. When an investment results in a loss, it is tempting to attribute the loss to randomness or to unavoidable and unpredictable occurrences that are part of stock market investing. However, where there are humans at work, there will be mistakes. In this report, we elaborate on how we distinguish between chance and mistakes, how we recognize and analyze mistakes, and how we learn from them.

Three avoidable mistakes
Generally, we distinguish between unavoidable and avoidable losses. An unavoidable loss is the result of an event that was unpredictable and therefore unexpected. A sudden health-related resignation of a key leader in management or a groundbreaking innovation by a competitor may serve as examples. Avoidable losses, on the other hand, originate from mistakes made during the investment process. Such mistakes can be prevented but never entirely eliminated. In our analysis of mistakes, we distinguish between three types of mistakes: information-based mistakes, cognitive mistakes and emotional mistakes.

Information-based mistakes
Preventing information-based mistakes is about gathering all relevant and available information prior to making any conclusions or decisions. Reading annual reports, analyzing conference calls with management, screening the news, interviewing clients and competitors, learning about the technical specifications of a company's products, etc. are all part of our standard research. It still happens that we miss an important piece of information that could have materially altered our decision if it had been discovered in time. In that case, we speak of an information-based mistake.

Here is an example from our own past: In the years 2012 and 2013, we were invested in John Deere, a US company known for its agricultural machines. We were impressed by their strong revenue recovery after the great financial crisis. We assumed that farmers had regained the confidence to invest in harvesters and tractors again after money was tight during the crisis. This assumption was missing an important piece of information: The Obama regime had passed a tax package intended to stimulate economic recovery. Section 179 of that package said that newly acquired farm equipment is 100 % tax-deductible in the first year instead of the usual depreciation schedule over the life time of the product. There were rumors that Section 179 would not be renewed for fiscal year 2014. Thus, the strong increase in revenue was not pent-up demand, but rather purchases made ahead of schedule. Sure enough, John Deere's sales declined in the years 2014, 2015 and 2016. This example illustrates that it is impossible to arrive at the right conclusion without a complete set of information. Sometimes, this information may not even be directly about the company, but about the broader economic setting or the situation of the company's clients.

Cognitive mistakes

Cognitive mistakes happen when we misinterpret the available information. During our extensive research, we gather all necessary information to make the right decision. Incorrectly interpreting that information, however, can lead to bad investment decisions that negatively impact the portfolio's return.

Let's use a fictional example to illustrate a multitude of interpretations for a given piece of information. An employee of a company we are invested in tells us the following: "Customer service is experiencing a steep increase in complaint calls." What are we going to do with this information? Our first reaction might be to assume that customer satisfaction must be decreasing, perhaps because the quality of the products has worsened recently or perhaps because sales reps' attentiveness has deteriorated. Such instances could lead to more complaint calls, which would be an indication of decreasing sales and loss of good reputation. Let's not jump to conclusions, though. Could it not be completely different? Maybe the company has introduced many new products in recent months and has gained many new customers in the process. In this case, the increase in complaint calls would merely be a function of the growing business, because more clients imply more service hotline calls. There may even be a third interpretation. What if the word is spreading among customers that the complaint hotline is providing superb additional customer service that actually takes complaints seriously? Maybe more customers want to take advantage of that. As it turns out, the initial statement that complaint calls are on the rise is quite difficult to interpret without further context. If we don't look further into this matter, but simply guess instead, then we make a cognitive mistake. We should clarify why something has changed. We must always dig deeper, even if it turns out to be time-consuming or inconvenient.

Unfortunately, we have also made this type of mistake before. When we first invested in the Dutch dredging company Boskalis, we had not thought enough about the firm's fleet maintenance. Boskalis provides dredging and heavy-lift services relating to the construction and maintenance of maritime infrastructure. The company was running at full capacity back then, which we saw as a sign of success. However, running the fleet at full capacity is only possible when maintenance work is postponed. We completely missed that point. We had all information that we needed to arrive at the right conclusion. Instead, we misunderstood the situation. The following year, many vessels were underutilized in order to catch up with maintenance, which led to a decline in revenue and profit, which was reflected in the falling stock price.

Emotional Mistakes
Emotional mistakes are the most annoying of the three. When we make an emotional mistake, we actually have all the relevant information and make the right analysis, but then we ignore it and hope that whatever we wanted to be true somehow becomes true. This sort of wishful thinking is only one kind of mistake among many of this third type. Other emotional mistakes may happen when we are under pressure to find a new investment or when we hang on to an old investment too long, because it has done well in the past. There is a whole field of research on behavioral mistakes such as overconfidence, regret aversion, status quo bias, etc.

We have also had our share of experiences with this type of mistake. Back in 2014, we knew that the iron ore price was in a free fall due to oversupply in the market. We also knew that the break-even points of the major iron ore companies such as BHP or Rio Tinto were still much lower. Furthermore, we knew that the stock price of the Australian iron ore infrastructure service provider MRL – at the time the company of our interest – showed a correlation of 0.7 with the iron ore price. We really liked the company and were annoyed with the development of the iron ore price. We spoke to a few industry experts who provided us with an opinion on the iron ore price development that fit our investment case and we decided to trust those experts. At that point, these experts claimed that the iron ore price had reached its lowest point and they expected the recovery to be just around the corner.

We wanted to increase the number of investments in the portfolio during that time and were therefore under pressure to find a new position. The investment we ended up making was poor and the lessons thereof painful. We decided that we never again want to solely trust the opinion of an expert we talk to, but much rather have that person detail the logic supporting their opinion. A second analyst in the team must then determine whether we have a reasonable basis supporting the opinion. This new approach to using external expertise has since helped us to better identify wishful thinking and other emotional biases.

Improving the investment process
There will always be uncertainty in the stock market and we never have complete access to all the information about a company. Still, the examples of mistakes mentioned above could all have been avoided and they therefore offer an opportunity to learn. When it comes to selecting stocks, nothing can replace experience. This experience is only valuable, however, if we are willing to learn. We want to learn from our mistakes in order to continuously improve our investment process and to better understand our own investment behavior. This is easier said than done.

Failing forward
The foundation of this learning process is honesty, both within the team and – most importantly – with oneself. Admitting that I have not gathered all relevant information is uncomfortable. Accepting that I have found all the necessary information but have misinterpreted it is far more difficult. The realization that I had all necessary information at my disposal and drew the right conclusions, but still let my decision be guided by emotions and biases hurts my pride every time. Consciously addressing the fallibility of each team member and actively fostering a culture where mistakes are seen as an opportunity to learn sets the required foundation to admit mistakes by the individual as well as the team collectively. When we can admit a mistake, we can learn from it and improve our investment process.

At ANREPA, we decided to write an investment report for each stock, which contains all information, interpretations and conclusions. This allows all investment committee members to be fully informed and to familiarize themselves with all assumptions and conclusions, which facilitates a collective decision by the team. Consequently, the team takes responsibility collectively, which we hope will foster a proactive analysis of mistakes. As mentioned initially, we can never completely eliminate these three types of mistakes. A team culture that actively addresses mistakes as a learning opportunity enables the necessary dialog for the learning process, so that mistakes are hopefully at least not repeated.

Conclusion

Accepting the fallibility of each individual and promoting a proactive analysis of our own mistakes is the core of a constructive culture, where each mistake is supposed to help us move forward and improve. Role model seniors and the collective interest in the learning process facilitate the necessary dialog in a sometimes uncomfortable review. The learnings that can be drawn from this experience are irreplaceable, though, and lead to continuous improvement of our process and each individual analyst.

First release: October 2018
Recent version: December 2024

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