



# Behavioral Matters

Insights from the application of Behavioral Finance | Issue 4

## Aching Conviction

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SKILL VERSUS LUCK

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## INTRODUCTION

*Behavioral Matters is a series of essays on the application of Behavioral Finance written specifically for professional investors and portfolio managers.*



“Doubt is not a pleasant condition, but certainty is absurd.”

- Voltaire

The term conviction is used universally among professional investors to suggest that rigorous thinking has preceded a buy or sell decision. What is really backing up conviction? Does conviction reflect knowledge and wisdom accumulated over years or is it merely bluster? Understanding the nature of conviction is essential to improving any investment discipline.

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## BELIEF IT OR NOT

The dictionary defines conviction as a "fixed or firm belief". How are beliefs formed? Are people aware of their complete set of beliefs? Can we consciously edit or manage beliefs?

Beliefs are created, stored and managed almost entirely within the unconscious part of the brain, according to modern Cognitive Science. In commenting on beliefs Harvard Psychologist Daniel Gilbert points out that "research suggests that people are typically unaware of the reasons why they are doing what they are doing, but when asked for a reason, they readily supply one." Hersh Shefrin, the noted Behavioral Economist, suggests "... we like to think that we are thinking, when often we are just really feeling. That goes on all of the time in the investment business ..."

The unconscious, and the beliefs residing there, are credited for roughly 95% of all our daily decisions. These unconsciously driven decisions occur and are being implemented well before we are even consciously aware that a decision is required. The lightening fast processing of the unconscious, together with its content being obscured from ready analysis, call in to question our dependence on conviction.



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## I SELL, THEREFORE I HAVE CONVICTION

Selling is a relatively unstudied aspect of investing. Few managers, if any, know how well their selling works. Yet, sell they must. Some selling is pragmatic — initiated to satisfy outflows. Creating liquidity to fund new buys is among the most commonly cited motivations for selling. Others include invoking a stop-loss, portfolio rebalancing and reacting to news about a company.

But what about strategic selling? Those sells driven purely to achieve enhanced performance. Author and financial writer Jason Zweig says "... I've yet to have anyone provide evidence that their sell discipline works. Performance, even above the benchmark, is not proof that your selling is good."

The absence of objective analysis on selling effectiveness leaves much to chance. To fill the void "Managers and analysts rely on crude heuristics to measure fundamental value ..." says Hirsh Shefrin. Less rigorous by their very nature, these efforts are highly susceptible to shortcomings in cognition and biases.

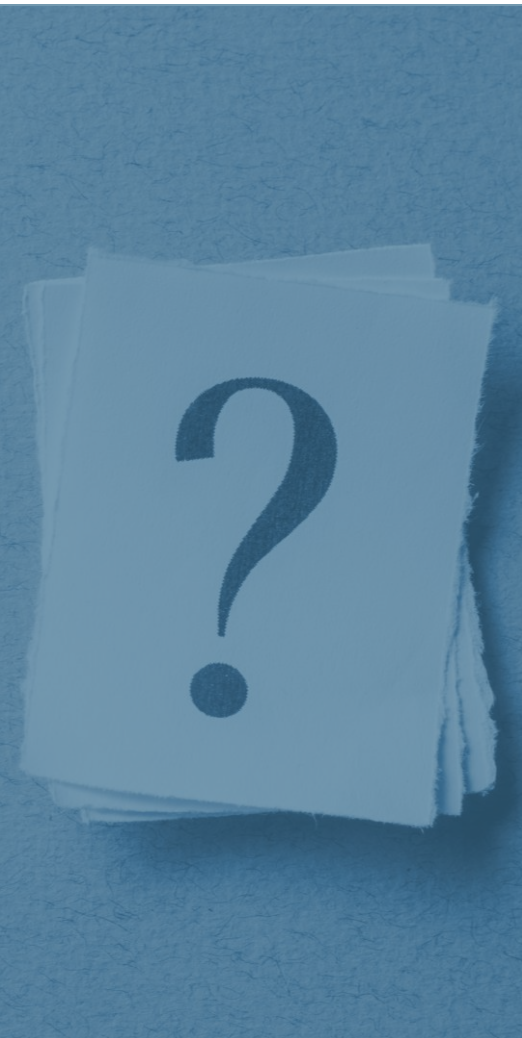
In his highly acclaimed book *The Black Swan*, Nassim Nicholas Taleb says about conviction "First, we are demonstrably arrogant about what we think we know." One factor undercutting conviction he explains this way, "much of what we ascribe to skills is an after-the-fact attribution," which leaves managers with the dual problem of perhaps making behaviorally motivated decisions initially and then rationalizing the decisions afterward. With such an active unconscious protecting us from thinking or feeling badly about ourselves just how can a manager develop bankable conviction?



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## QUESTION YOUR CONVICTION



Understanding how effective your convictions are requires that you both question them regularly and, perhaps more importantly, measure exactly how well they work. Questioning conviction or judgment on the fly is difficult. It requires that you suspend all of the natural impulses driving you at the moment (those unconscious forces) and take stock of what, other than strategy and discipline, might be propelling your decision. Rigorous measurement, on the other hand, can be approached with greater dispassion and yield elements of self-knowledge that can be capitalized upon and lead to higher performance.

Overconfidence, Anchoring, Belief Perseverance and Self Attribution are a few of the well documented behavioral traps that can become pseudo-conviction. All that stands between you and misplaced conviction is your own disbelief.

## ENDNOTES

1. *Stumbling On Happiness*, Random House, 2006, by Daniel Gilbert.
2. *Corporate Behavioral Finance*, McGraw-Hill, 2007, by Hersh Shefrin.
3. "Mind Games", "Welling@Weeden", an on-line research journal, May 11, 2007, Volume 9, Issue 9, an interview with Jason Zweig.
4. *Your Money and Your Brain*, Simon & Schuster, 2007, by Jason Zweig.
5. *The Black Swan — The Impact of the Highly Improbable*, Random House, 2007, by Nassim Nicholas Taleb.