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Blog Post: Book Review – The Undoing Project: A Friendship That Changed Our Minds

I recently read The Undoing Project: A Friendship That Changed Our Minds by Michael Lewis. When Lewis presented at the CFA Society Vancouver 50th Anniversary Dinner in November 2015, he mentioned that he was working on a book featuring the collaboration between Israeli psychologists, Daniel Kahneman and Amos Tversky. I had previously read Kahneman's book Thinking, Fast and Slow and was excited to read about how he and Tversky had developed some of the ideas that led to that book.

The Undoing Project took me back to my undergraduate days at UBC, where coincidentally Kahneman was a professor for a few years from 1978. I took several courses in psychology as my arts elective while pursuing a BSc. The book illustrates some of the examples that Kahneman and Tversky used, initially on undergraduate students, where students were asked fairly straightforward probability questions. The answers they collected demonstrated that the human mind actually makes systematic errors when assessing probabilities. I vividly remember being amazed when our professor told us the correct answers, which in retrospect were obvious, to highlight the errors our intuitive brains make.

The Undoing Project was very much a refresher course and served to reinforce some of my key takeaways from Kahneman's book, especially as I apply them to our investment process today. When making investment decisions it is important to know that we have a number of ingrained biases that are working against us. Investing is uncertain and probabilistic at the best of times, and the human mind infact does a very poor job of making decisions based solely on intuition in this world.

It is critical to step back and make your decisions based on factual information, while at the same time being aware that these biases have the potential to cause you to make errors. Some people have interpreted this work as evidence that it is very difficult for active management to outperform. My own interpretation is that this supports why Ben Graham's "Margin of Safety" (Chapter 20 of The Intelligent Investor) is critical to long term investment success.

When you invest you need to stack the odds in your favour. You need to recognize that no matter how much research and analysis you do, you can never have a complete understanding of the investment opportunity and that it could be a mistake. Therefore you need to buy a security at a sufficient discount in order to account for this. And I'm not talking about buying a stock that may be worth $50 for $49.

Interestingly, one of the most significant biases that can impair our decision making is confidence bias. In a world with unlimited information and data available to investors, the more information people have about an investment, the more confident they become – even if that information is of very little value. The tendency here is to decrease your "margin of safety". As a result of all this and other inherent biases we, as investors, have an internal battle.

We need to be investing in opportunities where the upside and downside are heavily skewed in our favour. This is easy to say in theory, but hard to do in practice. However, understanding the role of psychology and people's hardwired biases when investing can help. These biases, found in almost everyone, can cause systematic errors when market participants are valuing stocks. For us, these systematic mispricing's create opportunities. We are always looking for these pockets in the market and you may have heard us call them "inefficient" parts of the market.

Interestingly, Michael Lewis has written a couple of books about people who have identified "inefficiencies" in their arenas and went on to capitalize on them. The Big Short highlights a small group of people who had an alternative view during the US housing boom. Moneyball highlights Billy Beane and a team of data-driven baseball enthusiasts who figured out an inefficiency in the way baseball talent was rated.

Overall it was a great read, and if you found Kahneman's book too technical, Lewis' book is an easier read and will leave you with some of the key points from Kahneman and Tversky's work. Being reminded of how many ways our brains set us up to fail in investing, I think I'm going to have to sharpen my pencil and demand an even higher margin of safety next time!

David Barr,
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