



# Rationality is an intolerable tyrant, meet him with reasonability



Aadil Omar  
HEAD OF EQUITY RESEARCH

## KEY TAKE-AWAYS

- *In an uncertain world where human biases are prevalent in decision-making, people often attempt to compensate for their known biases by striving for perfect rationality.*
- *It helps to recognize that consistently making 100% rational decisions in fields where outcomes are influenced by human emotions (like investing, rather than science or math) is nearly impossible. It is best to be reasonable about this and put in place methodologies to help reduce your degree of irrationality, rather than being intolerant.*
- *Some approaches to assist with this include: delaying your judgement on an issue (or not immediately accepting your intuition); seeking out and listening*

*to a dissenting voice; and building algorithms for decision-making where possible.*

**S**ome years ago, I heard an investment professional argue in favour of his emotional nature. He claimed being somewhat emotional made him a better investor than those who are more stoic and emotionally resolute. His argument ran along the following lines: a person more attuned to his emotional side has a better understanding of self and can see traits in others that might be missed by those less emotionally aware. Specifically, he sighted an acute awareness of body language and communication style that made him a particularly good judge of character. These traits enabled him to spot fraudulent management teams well ahead of the rest of the market. It also helped him identify hard-working and sincere colleagues.

The error in his logic lies in plain sight – he confused his emotional nature and personal preferences for emotional intelligence. Needless to add, the strengths he identified did not prove particularly helpful in generating superior investment returns.

The above tale is amusing given all we now know about the biases and error-laden judgements human beings are prone to. The list of behavioural biases afflicting the human psyche already seems endless, yet the corpus of literature detailing peculiarities of perception (responsible for misjudgements) grows ever more voluminous. For instance, from the anecdote above we can identify a number of common biases: *fundamental attribution error* (also known as the halo effect, the tendency to believe being proficient in one domain translates to being proficient in a number of others); *the endowment effect* (because you possess a skill, the skill is more valuable than other skills); *confirmation bias* (citing specific examples to reinforce your view); and *blindness to context* (failure to recognise that the skills/attributes you possess might have little bearing on the objectives you're trying to meet). This list is nowhere near exhaustive and still the errors feel numerous for such a common tale.

### **Rationality the tyrant**

It is easy to identify and criticise the irrationality in others. In fact, rationality signalling (a term we just

coined referring to the tendency people have of pointing out the irrationality of others) seems to have become a popular pastime. We seem to treat rationality as an on/off switch that people can summon at will, provided they know enough about the subject matter and we're there to point out how susceptible to error they are.

The remarkable thing is that we commit similar errors of judgement in thinking that the biases do not apply to us – or at least apply to a lesser extent than they do to others who know less about the subject matter. The ambition (for both ourselves and others) of a Mr Spock-like<sup>1</sup> practitioner of perfect rationality might simply be indulgent. Perhaps being more *reasonable* is a better course of action.

### **Markowitz was a reasonable man**

Harry Markowitz, Nobel Prize winner and father of the Capital Market Efficient Frontier, a crucial underpinning to the development of the Capital Asset Pricing Model (CAPM), was once asked how he invested his own money. He responded:

*"I visualised my grief if the stock market went way up and I wasn't in it – or if it went down and I was completely in it. My intention was to minimise my future regret. So I split my portfolio 50/50 between equities and bonds."*

Being rational and being reasonable are often not the same thing. Markowitz understood the distinction. Although the Efficient Frontier was mathematically sound and logically consistent, Markowitz understood that his humanity would likely get in the way. His ability to maintain an uninterrupted adherence to the theoretical constructs of his prize-winning theory would have been a herculean task in the face of emotional pain when the market went against him. It is one thing to understand what you should do as a rational actor before the fact, but it's completely different when the fire of the moment has you in its grip.

### **Learning to be reasonable**

Knowledge and even the awareness of our biases do not automatically grant us discretion over them; in as much as a diagnosis of some chronic condition,

<sup>1</sup>Star Trek's Mr. Spock is often cited as the exemplar of logic and rationality. Alternate character assessments, however, view him as a "straw man" of rationality used to show (incorrectly) that human emotion and irrationality are better than logic.

diabetes for example, is not a panacea. Being diagnosed as a diabetic will not enable you to instruct your pancreas to start producing the requisite levels of insulin for metabolism. Knowledge and awareness are, however, useful in formulating plans to act reasonably within the constraints of our environment. A diabetic with knowledge of his diagnosis can arm himself with synthetic insulin and make conscious adaptations to diet and lifestyle to offset the impact of the disease. Likewise, being aware of our biases empowers us to anticipate the moments when we're most likely to fall victim to misjudgements and build in contingencies. It allows us to make environmental alterations that facilitate more unbiased and rational decisions.

Daniel Kahneman, the foremost authority in the field of behavioural finance and author of the best-selling book, "Thinking Fast and Slow", offers up a number of suggestions for being more reasonable when approaching rationality. Here are a few we thought worth sharing:

**Delay your intuitions:** It is often easier to arrive at broad truths in

domains that exist outside of human influence, like physics or chemistry. The laws governing these domains do not change on the whim of the participants experiencing them. But domains wherein participants both experience and impact the environment, like financial markets or economies, embed greater degrees of uncertainty. These environments are more dynamic and the rules governing them are more likely to change. We can only really know what the rules were in hindsight. The truth we seek in these domains has less to do with an objective reality; it is more about understanding what the competing views are and what these views might be informed by. It is challenging to understand the extent of the complexity in the world we live in, but in delaying our judgements/intuitions, we have a better chance of constructing a more complete picture.

**Seek out and listen to the dissenting voice:** Many of the biases we face emanate from snap judgements drawn from processing the most readily available information. This information interacts with our beliefs and we draw judgements. If we hold beliefs that are not applicable to the circumstances or draw on incomplete information

(we frequently have a combination of these), we risk drawing incorrect or partially incorrect conclusions. Seeking out the dissenting voice means listening to those who have different beliefs to our own, or those who might have different information – a most uncomfortable task indeed if you're not used to it. But having a more complete picture, including the views we do not agree with, enhances our understanding of given circumstances.

**Build algorithms for decisions where possible:** We're often most susceptible to misjudgements in the fire of the moment or when our decision-making budget has been exhausted. However, we can set rules in calmer, more considered times when we're free from the demands of a burning issue. These rules could range from where you place your keys every evening when you return home, to automating a monthly contribution for retirement planning.

Being rational is a mammoth task, and being rational in the heat of the moment is nearly intolerable; but we can confront the struggle through reasonable preparation. Implementing and adhering to rules that prevent the possibility of ruin; building out diverse teams with varied perspectives; and making room for the dissenting voice are some of the things we can do when building portfolios. These measures cannot be simply rote in execution. They must be accompanied by a deliberate and conscious effort to improve decision making while guarding against the temptation to slip into habit.

What we can learn from the irrationality around us is not how to be rational, but rather that we are all irrational (in some circumstances). Preparing for the moments when irrationality will inevitably find us is the good fight, and reasonability is what we should aim for. ■

*With 14 years' investment experience, Aadil joined Prudential in July 2013 as an Equity Analyst. In August 2018 he joined a global equity hedge fund in London, before returning to Prudential in January 2020 as Head of Equity Research and joint-Portfolio Manager of the Prudential Equity Fund. He holds a BCom degree (Hons, cum laude) from the University of Pretoria and a Masters in Finance degree from INSEAD. He is also a CFA charterholder.*