

## What Good, in the Practical World, is the Thought System Indicated by the List?

*This article is part of a [multi-part series](#) on human misjudgment by Phil Ordway, managing principal of [Anabatic Investment Partners](#).*

What good, in the practical world, is the thought system indicated by the list? Isn't practical benefit prevented because these psychological tendencies are programmed into the human mind by broad evolution so we can't get rid of them? By broad evolution, I mean the combination of genetic and cultural evolution, but mostly genetic."

"The answer is the tendencies are partly good and, indeed, probably much more good than bad, otherwise they wouldn't be there. By and large these rules of thumb, they work pretty well for man given his limited mental capacity. And that's why they were programmed in by broad evolution. At any rate, they can't be simply washed out automatically and they shouldn't be. Nonetheless, the psychological thought system described is very useful in spreading wisdom and good conduct when one understands it and uses it constructively. -Charlie Munger

Carl Braun's communication practices - All Braun communications had the "Five W's" (Who? What? Where? When? Why?) and if you left out the "why" you got fired.

Pilot training in simulators - abilities attenuate with disuse

Clinical training in medical schools - Watch one, do one, teach one.

The U.S. Constitutional Convention - "Totally secret, no vote until the whole vote, then just one vote on the whole Constitution. Very clever psychological rules, and if they had a different procedure, everybody would've been pushed into a corner by his own pronouncements and his own oratory and his own... And no recorded votes until the last one. And they got it through by a whisker with those wise rules. We wouldn't have had the Constitution if our forefathers hadn't been so psychologically acute. And look at the crowd we got now."

Granny's Rule - eat your carrots or you don't get your ice cream; "[people should] organize their day so they force themselves to do what's unpleasant and important by doing that first, and then rewarding themselves with something they really like doing."

Harvard Business School's emphasis on decision trees - "high-school algebra works in real life"

"One of the advantages of a fellow like Buffett is that he automatically thinks in terms of decision trees." - Charlie Munger<sup>[71]</sup>

Post-mortems at J&J - "At most corporations if you make an acquisition and it turns out to be a disaster, all the paperwork and presentations that caused the dumb acquisition to be made

are quickly forgotten. You've got denial, you've got everything in the world. You've got Pavlovian association tendency. Nobody even wants to even be associated with the damned thing or even mention it. At Johnson & Johnson, they make everybody revisit their old acquisitions and wade through the presentations. That is a very smart thing to do. And by the way, I do the same thing routinely."

Charles Darwin - the great example of avoiding confirmation bias, which "has morphed into the extreme anti-confirmation-bias method of the 'double-blind' studies wisely required in drug research by the F.D.A."

"Sam Walton won't let a purchasing agent take a handkerchief from a salesman - he knows how powerful the subconscious reciprocation tendency is."

The Warren Buffett Rule for Open-Outcry Auctions: Don't Go. - "We don't go to the closed-bid auctions too."

### **Update**

**Granny's Rule in the military** - make your bed. "If you make your bed every morning you will have accomplished the first task of the day. It will give you a small sense of pride and it will encourage you to do another task and another and another. By the end of the day, that one task completed will have turned into many tasks completed. Making your bed will also reinforce the fact that little things in life matter. If you can't do the little things right, you will never do the big things right. And, if by chance you have a miserable day, you will come home to a bed that is made—that you made—and a made bed gives you encouragement that tomorrow will be better."

**Granny's rule at work: Read the SEC filings** (or other independent, original-source document) first thing in the morning. Set the right tone for the day, make sure something is accomplished. Then get your crossword puzzle with breakfast while you read some news - that part may be more enjoyable but it's not as important. Also, remember that the order of the research process's steps matters greatly. And rub your nose in your mistakes. Do a pre-mortem and a post-mortem.

### **What special knowledge problems lie buried in the thought system indicated by the list?**

"Now we're talking about a type of human wisdom that the more people learn about it, the more attenuated the wisdom gets. That's an intrinsically paradoxical kind of wisdom. But we have paradox in mathematics and we don't give up mathematics. I say damn the paradox. This stuff is wonderfully useful. And by the way, the granny's rule, when you apply it to yourself, is sort of a paradox in a paradox. The manipulation still works even though you know you're doing it." -Charlie Munger

### **Don't we need more reconciliation of psychology and economics?**

"My answer is yes, and I suspect that some slight progress is being made. I

have heard of one such example. Colin Camerer of Caltech, who works in “experimental economics” devised an interesting experiment in which he caused high I.Q. students, playing for real money, to pay price A+B for a “security” they knew would turn into A dollars at the end of the day. This foolish action occurred because the students were allowed to trade with each other in liquid market for the security. And some students then paid price A+B because they hoped to unload on other students at a higher price before the day was over. What I will now confidently predict is that, despite Camerer’s experimental outcome, most economics and corporate finance professors who still believe in the “hard-form efficient market hypothesis” will retain their original belief. If so, this will be one more indication of how irrational smart people can be when influenced by psychological tendencies.” –Charlie Munger

**If the thought system indicated by this list of psychological tendencies has great value not recognized and employed, what should the educational system do about it?**

A mystery...to be continued

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**What causes smart people to do dumb things?** Adam Smith, author of the book “The Money Game,” interviewed Warren Buffett and asked that question. Buffett replied, “That’s the big question. Why do they do it in investing? Why do they do it in managing businesses? Because you have all these smart people out there. The money doesn’t go to the people with the highest I.Q. There would be a very poor correlation between I.Q. and investing and results. And you say to yourself why does somebody with a 500-horsepower motor only get 100-horsepower out of it? And I would say that if you look at the intellect as being the horsepower that’s available, but you look at the output as reflecting the efficiency of that motor, it is rationality that causes the capacity to be translated in output. **Now what interferes with rationality? It’s ego. It’s greed. It’s envy. It’s fear. It’s mindless imitation of other people. I mean, there are a variety of factors that cause that horsepower of the mind to get diminished dramatically before the output turns out. And I would say if Charlie and I have any advantage it’s not because we’re so smart, it is because we’re rational and we very seldom let extraneous factors interfere with our thoughts. We don’t let other people’s opinion interfere with it. We try to get fearful when others are greedy. We try to get greedy when others are fearful. We try to avoid any kind of imitation of other people’s behavior. And those are the factors that cause smart people to get bad results.**”<sup>[72]</sup>

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More questions:

- What psychological factors and tendencies are missing from the list? What helpful examples are missing?
- What are the 10-12 microeconomic models that, combined with these psychological tendencies working for good, can produce lollapalooza business results?
- What absurdities that exist today – likely caused by a confluence of psychological tendencies – will be exposed as misjudgments over the next 5, 10, or 20 years?

## **Updates from the work of Kahneman and Tversky, et al.**

Other useful concepts to consider:

- System 1 and System 2
- What You See is All There Is (WYSIATI)
- Base Rate Neglect
- The Planning Fallacy
- Narrative Fallacy
- Anchoring
- Availability
- Substitution
- Loss Aversion
- Framing
- Sunk Costs
- Divergent measures of happiness / remember self vs. experiencing self

I particularly try to use a “second look” to engage System 2. Putting down a file or pausing the research process has a lot of value to me, just as does when I come back to a stalled crossword puzzle after some time doing something else. There is a reason why great ideas often happen in the shower.

Other ideas:

- Address complex problems by sub-dividing them
  - Israeli military’s practice of subdividing personal performance into smaller bits to find officer candidates
  - How should we evaluate investors, managers, etc.? Buffett wants managers who are energetic, honest, and smart. So take each of those three categories and evaluate them individually.
    - I might add humility, an attitude of partnership, frugality,

My “favorite” factors to try to avoid:

- Sunk costs
- Commitment and consistency
- Narrative fallacy

<sup>[71]</sup> May 5, 1995 edition of “Outstanding Investor Digest,” p. 50

<sup>[72]</sup>

<http://www.prnewswire.com/news-releases/buffett-warns-on-level-of-stock-prices-margin-of-safety-has-vanished-in-exclusive-interview-with-adam-smith-77907392.html>