

Half-hearted is Half-minded

After discovering the next great investment idea, why is it so easy to start with a half-sized position, watch it a bit, and then go full-sized later? What is later? Is it when the stock is down 10%, and you get to average down? Or is it later, after the next positive quarterly earnings report, when the stock is 10% higher? "Later" can be either of them; and strangely, both feel kind of good, or at least don't feel that bad.

When you go half-hearted and size up higher, you get some "feelgood". Let's call that about 6 units of feelgood; and you don't really regret not investing the other half because you never had it in the first place.

Danny Kahneman and Amos Tversky taught us about loss aversion, and that losses feel worse than similar gains feel good. Depending on your level of risk-aversion, even the most level-headed among us all tend to feel about twice as bad over a loss than we would over a similarly sized gain. So if you instead size up *after* the stock drops, you do get some feelbad. In this scenario, we feel about 12 units of loss. This is painful, but not debilitating. There is no endowment effect on the half you didn't invest. We conjure up notions of being smart about holding some back, we convince ourselves that we are pleased to be averaging down. We sleep pretty well at night.

Conversely, if we go full from the outset, and the stock immediately moves higher, it feels good. Let's call that 12 units of "feelgood" (twice as many as units as when we went half-sized). But if the stock immediately moves 10% lower, it feels *terrible*. That's 24 units of feelbad, and it is almost impossible not to beat yourself up for being too impatient. It isn't so easy to sleep at night.

In other words, it just feels good going into any investment to "start with half". Similarly, when exiting a trade, it also feels pretty good to start by "selling half". Ask yourself, how many times have you done this? If it feels good to you and nearly everyone to buy half or sell half, then we have to ask ourselves the question: **is feeling comfortable the best way to invest?**

Efficient Market Answer

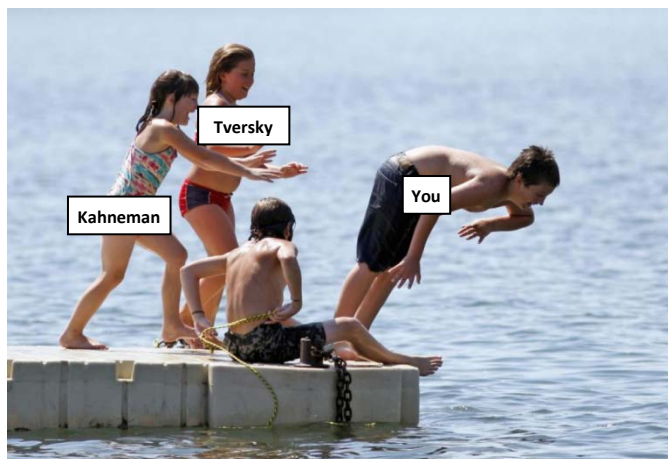
Assume the stock payoffs are symmetrical in your time horizon (e.g. it can either go up by 10% or down by 10%) and there is a 50% chance of being right or wrong. In the "half-hearted" strategy, again if we are flipping coins, we'll get an average of 3 units of feelbad over time. In the "full-throttle" strategy, we'll average 6 units of feelbad. Yet the expected returns of owning the stock are zero. It doesn't mathematically matter if you go half or go full – it just feels like it does.

Behavioural Market Answer

But we aren't in this business because we think we are good at flipping coins. Few of us active investors believe we are flipping coins at all.¹ Some might actually believe that, following their fundamental work and spotting a behavioural bias by Mr Market, that they face a 65% chance of being right. Some others might actually believe they indeed are flipping coins, but are facing positively asymmetric payoffs (e.g. losing 10% vs making 20%). Even others might think they are facing asymmetric payoffs *and* have a 65% chance of being right.

And in every single one of these scenarios (positive probabilities, asymmetric returns, or both) **over time, it just never makes sense to start with half.** That's just math.

So, if you've done your work, don't be the prospect-theoretical investor that Kahneman and Tversky wrote about. If you think you have the analytical edge, don't dip your toe in the water, just jump in.



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¹ And whether or not some, most, or all of us are is another question.