DSP Transcript

Foundations Edition III: The Chief Problem

Dec 2025

The investor's chief problem – and even his worst enemy – is likely to be himself.

Benjamin Graham, The Intelligent Investor

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The Chief Problem

"The fault, dear investor, is not in our stars and not in our stocks but in ourselves".

In this Foundations Edition we focus on what may be the only lasting edge left for investors: behaviour.

Many readers are probably familiar with the classic psychology experiments of Solomon Asch on conformity, Stanley Milgram on obedience, and the Dunning Kruger effect. Here we look at a few lesser known studies that are just as interesting and offer investors practical ways to suffer a little less at their own hands.

People hardly change and so neither do markets. The investing stories are the same twenty years, two hundred years or even two thousand years apart.

Protecting yourself from behavioural biases is hard. Knowing about them is not enough. Neither is experience. Like Odysseus sailing past the sirens, we must tie ourselves to the mast in advance. We need systems that stand between us and our worst impulses: checklists, rules, pre committed responses and trusted partners who act as circuit breakers.

This edition is about the sirens. And about the ropes we need before their songs begin.

Lure Of Complexity: Bavelas Experiments

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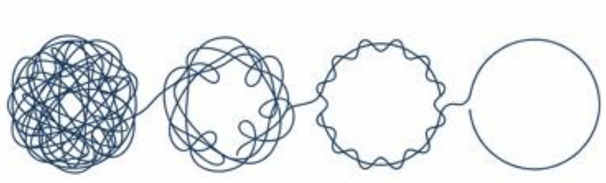
An interesting group of experiments was run by Professor Alex Bavelas in which he wanted to see how people react to simple rules versus complex ones. Two subjects, Smith and Jones, sat in separate rooms, each looking at slides of biological cells. Their task was to decide whether each cell was healthy or sick. They had two buttons, Healthy and Sick, and two lights, Right and Wrong. They were told that by trial and error they could learn to tell healthy cells from sick ones.

For Smith the feedback was real. When he was correct, his Right light flashed, and when he was wrong, his Wrong light flashed. The pattern in the slides was actually quite simple, so over time Smith discovered a straightforward rule and reached about eighty percent accuracy. Jones thought he was in the same situation, but his feedback secretly depended on Smith. If Smith was right, Jones's Right light flashed, and if Smith was wrong, Jones's Wrong light flashed, regardless of Jones's own choice. He was chasing order in what was effectively noise. Later both were asked to explain their methods. Smith described clear, concrete rules. Jones, forced to rationalize nonsense feedback, produced elaborate, subtle explanations full of conditions and exceptions. The twist is that Smith felt his own simple rules were childish and was genuinely impressed by Jones. When asked who would do better on a new test, most people, including many Smiths, chose Jones.

In reality Jones did not improve at all, while Smith did worse after trying to use Jones's complex rules.

Read More: https://newsletter.osv.llc/p/keep-it-simple-stupid



Truth is simple. If it was complicated, everyone would understand it.

Walt Whitman

Lure Of Complexity: Bavelas Experiments

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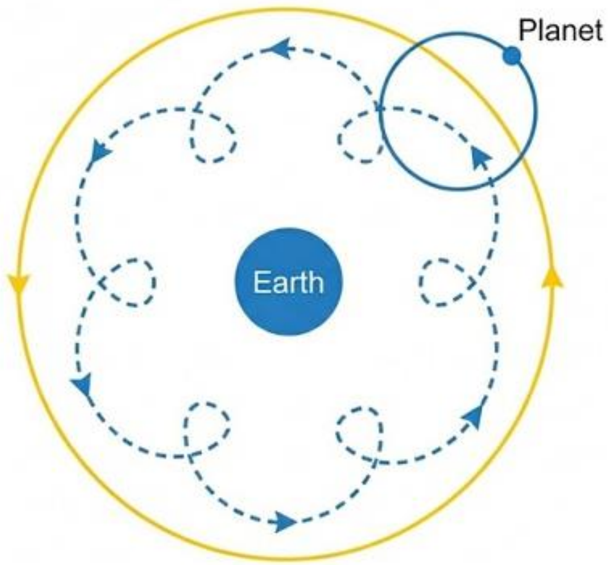
Implications

1. We confuse complexity with deep insight.
2. Wrong & delayed feedback in markets often rewards storytellers in the short term.
3. Simple rules seem naïve in a volatile, uncertain, complex & ambiguous world.

Guardrails

1. Focus more on clarity rather than cleverness (many managements/managers talk a lot without saying anything).
2. Simple asset allocation plans & products usually work the best.



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For 1,400 years, astronomy was held hostage by a single, intuitive falsehood that the Earth was the unmoving center of the universe. This assumption, codified by Claudius Ptolemy in the 2nd century, forced scientists into a millennium long spiral of complexity.

The problem was "retrograde motion." Occasionally, planets like Mars appear to stop, move backward across the sky, and then move forward again. This is impossible if everything orbits a stationary Earth in a perfect circle. To preserve the Earth-centric model, astronomers invented epicycles. They theorized that planets moved in small mini-circles, which in turn traveled along a larger circle around the Earth. When the data didn't fit, they didn't question the center they just added more gears.

Then, Nicolaus Copernicus (and later Kepler) stripped the gears away. By shifting the perspective and placing the Sun at the center, the chaos resolved into order. The complex "retrograde loops" vanished. They were revealed to be a simple optical illusion caused by the Earth, traveling on a faster inner orbit, overtaking Mars much like a passing car seems to move backward relative to you on a highway. The Ptolemaic system remains one of science’s greatest warning against complexity.

With enough variables, you can mathematically model a lie, but you cannot make it true. When a model requires a labyrinth of exceptions to work, the flaw isn't in the math, it is in the foundation.

Need To Belong: Cyberball

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The Cyberball paradigm is a simple psychology game used to study social exclusion. A person sits at a computer and plays a virtual ball tossing game with two other supposed players. At first, all three throw the ball to one another. After a few throws, the two others stop throwing to the real person and pass the ball only between themselves.

Nothing else happens. No insults, no shouting, no loss of money or status. Yet this tiny act of being quietly left out has very strong effects:

- People feel quickly hurt and upset, even though it is just a short computer game.
- Their sense of belonging, self worth, control, and meaning drops.
- Brain and body measures show that social exclusion activates areas linked to pain and emotion.
- Results are similar across ages, countries, and many variants of the game, so the effect looks very robust.

This happens even when they know it is just a short computer game and even when they are told the others are controlled by a computer.

In fMRI studies, when someone is excluded in Cyberball, the scan shows increased activity in brain regions that also respond when a person feels physical pain. In simple terms, the brain reacts to social rejection in a way that is almost like a physical injury. For such a small and harmless event, this is a dramatic and important finding. It shows how deeply humans are wired to care about being included.

Read More: https://scienceinsights.org/what-the-cyberball-experiment-reveals-about-social-pain/

'When you're just like everybody else, you've nothing to offer other than your conformity'.

Need To Belong: Cyberball

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Implications

1. Social exclusion feels to the brain like breaking a bone, so we are wired to do what everyone else is doing.
2. Fund managers also want to belong. Often, they copy the index & peers, so they do not look stupid if they are wrong alone.
3. Inside firms and boards, the fear of exclusion makes people stay quiet instead of challenging the main story. This lets risks build up over time.

Guardrails

1. Set clear limits on the most exciting and popular themes of the day, especially those that have run up strongly in the recent past.
2. Ask whether you would still buy the same themes after a sharp fall in price, assuming the core economic story has not really changed.
3. Write down in advance the clear conditions under which you will exit the crowded trades.

Locusts are solitary grasshoppers capable of a radical transformation. In their ordinary state, they live quietly and avoid one another. However, under specific conditions, the same animal changes its body, color, and behaviour, morphing from a shy individual into a member of a massive, destructive swarm.

The trigger is crowding. Unusual rains create concentrated food sources, forcing populations together. As insects feed side-by-side, constant tactile stimulation on their hind legs spikes serotonin levels in the brain. This neurochemical shift acts as a biological switch: the insect ceases to be solitary and is chemically compelled to join the mob.

Once flipped, the locust enters the gregarious phase, but this unity is driven by fear. The insects become restless and ravenous, forming marching bands not out of cooperation, but cannibalism. Research suggests the swarm moves forward because each locust is running to avoid being eaten by the hungry neighbor behind it. Physically, they develop brighter warning colors and stronger flight muscles to sustain this frantic migration. These dense, self-consuming swarms travel vast distances, stripping the land bare.

Crowding, sudden abundance and a surge of serotonin can turn quiet order into restless destructive frenzy. Does that pattern remind you of anything in human affairs?

Illusion Of Control: Langer Studies

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Ellen Langer's research on the illusion of control showed that people often feel they can influence random events whenever those situations resemble games of skill. She defined the illusion of control as expecting personal success to be greater than the objective odds justify.

In a classic lottery study, some participants chose their own ticket while others received one at random. Those who had chosen their ticket demanded much more money to sell it, as if their choice had improved its chances, even though all tickets were identical. In a card game of pure chance, people bet more heavily when they believed they faced a nervous and incompetent opponent rather than a confident one, as if a weak looking rival made them more likely to win.

Langer also manipulated familiarity and involvement. Lottery tickets with familiar symbols felt more valuable than tickets with strange markings. When people could practice responses on random devices or physically press the buttons themselves, they reported greater confidence and attachment to the outcomes, despite having no real influence. Field work at a racetrack and multi day lottery studies showed that simply thinking about a ticket over time increased confidence and resistance to trading it for objectively better odds.

Together, these findings showed that cues of skill such as choice, competition, practice, and personal involvement can mislead people into confusing feeling involved with actually changing outcomes.

Read More: https://thedecisionlab.com/biases/illusion-of-control

The illusion of choice is the most effective tool of control.

Noam Chomsky

Illusion Of Control: Langer Studies

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Implications

1. People are sometimes reluctant to trust hybrid strategies because they are not the ones making the allocation decisions, even when a sound, objective mechanical process has been shown to deliver better results over time.

2. Manual stock and fund picking provides strong cues of skill such as research, effort & compelling narratives, even though it typically drives pro cyclical behaviour & inefficient outcomes for most investors.

3. We often misuse Peter Lynch's idea, assuming that any product or service we personally use must be safe and therefore a good investment.

Guardrails

1. Do not speculate, automate. Systematic allocation and rebalancing are far more effective for most people than trying to actively manage them.

2. Consciously gravitate toward ideas and products that require you to do less. Make fewer decisions.

3. Build frictions for tinkering. Any change to your allocation must survive a cooling off period.

In many modern elevators the close door button is more often a comfort prop than control device. In the United States, accessibility rules under the Americans with Disabilities Act require elevator doors to remain open for a minimum period, usually about three seconds, so that people with mobility issues can enter safely. Pressing the close door button is not allowed to shorten that initial open time. As a result, in most newer lifts the button either does nothing for ordinary riders or only works when a firefighter or technician uses a special key. The button stays there because it feels good.

Humans like to believe they are in charge, so a useless button that lights up when pressed still reduces anxiety. Designers know this and quietly lean on the illusion of control rather than remind people that the elevator has its own schedule.

Similar placebos are scattered through cities. Many pedestrian crossing buttons in dense areas have no effect because timings are handled by central computers, yet the buttons remain. Office thermostats that click but do not change the temperature and some train door buttons that are rarely enabled play the same role. They give people something to do while the system quietly runs itself.

The important question is not where we push, but what genuinely yields.

‘Myside Bias’ & Enigma Of Reason

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Dan Kahan’s work on motivated reasoning shows that citizens often use their intelligence to protect their cultural or political identities rather than to seek truth. In studies of “motivated numeracy,” participants who were better at mathematics were also better at twisting the same data to reach the conclusion favored by their political group, especially on polarized topics such as gun control and climate risk. Instead of reducing bias, higher numeracy and reflective thinking can arm people with more tools to defend what they already believe, a process Kahan calls identity protective cognition.

Hugo Mercier and Dan Sperber, in The Enigma of Reason, argue that human reasoning evolved mainly for social purposes. Reason helps people justify their actions and persuade others, not neutrally evaluate evidence. In their “argumentative theory,” individuals generate reasons that support their existing views, while groups do a better job of correcting errors because others can challenge weak arguments. Here too, cognitive sophistication is double edged. Skilled arguers, who are often more educated or intelligent, are especially good at finding plausible sounding justifications for whatever they want to believe. Their reasoning can therefore increase polarization and dogmatism when it is not checked by critical discussion.

Taken together, Kahan and Mercier suggest that smarter people are not necessarily more rational in the everyday sense. Without the right social and institutional safeguards, their extra cognitive power mainly makes their biases more coherent and harder to dislodge. Intelligence becomes a lawyer for identity, not an evidence seeking scientist.

Read More: https://www.edge.org/conversation/hugo_mercier-the-argumentative-theory
https://www.discovermagazine.com/what-is-motivated-reasoning-how-does-it-work-dan-kahan-answers-989

Smart people believe weird things because they are skilled at defending beliefs they arrived at for non-smart reasons.

Micheal Shermer

‘Myside Bias’ & Enigma Of Reason

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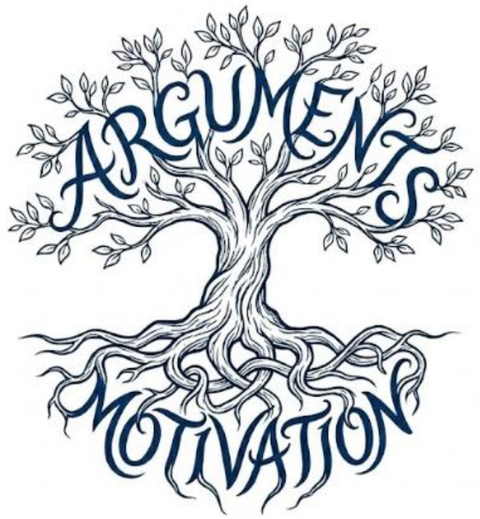

Implications

1. The smarter an investor is, the more brilliant arguments they can generate for their existing position, which can dangerously boost conviction & position size even when the evidence is mixed.
2. When your ideas underperform, you do not just see it as a loss of capital, you experience it as a loss of self. That triggers Identity Protective Cognition & nudges you to double down instead of cutting your losses.

Guardrails

1. Premortem: Imagine it is exactly 12 months from now. The investment has been a total disaster. Write down the story of exactly how it happened.
2. Before you buy, write down 2 quantifiable events that would force you to sell.
3. Create a Red Team whose sole job is to argue against the idea.

The Cottingley Fairies

Image: https://www.bbc.com/news/uk-england-leeds-55187973

In 1917, in the village of Cottingley in Yorkshire, cousins Elsie Wright and Frances Griffiths used a borrowed camera to take photographs that seemed to show them playing with small winged fairies beside a stream. Elsie's father assumed it was a prank, but local spiritualists were captivated. The images reached Sir Arthur Conan Doyle, creator of Sherlock Holmes, who had been invited to write a Christmas piece on fairies for The Strand Magazine. He treated the photographs as possible scientific evidence for a hidden spirit world and used them in a 1920 article and later in his book The Coming of the Fairies.

Doyle consulted photographic experts. One declared that the negatives showed no clear signs of tampering, and others could only speculate about trickery. Doyle interpreted this as strong confirmation that the girls had photographed real fairies. Decades later, in the early 1980s, Elsie and Frances admitted they had staged most of the scenes with paper cut outs based on children's illustrations.

Why did such an intelligent man believe? By then Doyle was a committed spiritualist who had lost his son and other relatives in the First World War and longed for proof of a world beyond death. The photographs fit his hopes, seemed to carry expert approval, and advanced his public campaign for spiritualism. His considerable intelligence simply produced better arguments for a conclusion his emotions had already chosen.

Where are you acting like Doyle, not Holmes?

‘You Can’t Not Believe Everything You Read’

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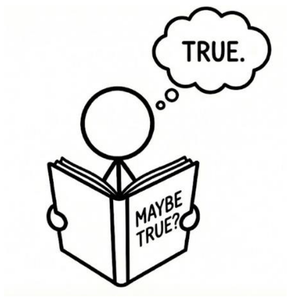
In 1993, psychologists Daniel T. Gilbert, Romin W. Tafarodi, and Patrick S. Malone ran a study titled ‘You Cannot Not Believe Everything You Read,’ testing whether people automatically accept statements as true the moment they understand them. The study asked a simple question with real life stakes. If a story clearly marks certain sentences as false, will people still let those false details shape their judgments when they are rushed or distracted.

When participants read short crime reports, some sentences were flagged as false. While reading, people either had to juggle a second task or they were under time pressure. Afterward they made decisions such as how long a sentence to recommend to the convicted. Even though the false lines were labeled, the rushed or distracted readers relied on them anyway. The result showed that understanding a sentence seems to place it in mind as true by default. Rejecting it takes a later corrective step that needs attention and time. When attention or time is scarce, that correction often fails, so the known falsehood still leaks into the final decision. This default belief step helps explain why repetition is powerful. The ‘Illusory Truth Effect” shows that repeated claims feel more credible because they are easier to process. Familiarity is mistaken for accuracy, and this happens even when people know the right facts.

Together the two ideas are a warning. First contact with a claim is fragile when you are busy, and repeated contacts will harden that first acceptance into confidence.

Read More: https://humanjourney.us/development/our-digital-world/you-cant-not-believe-everything-you-read/
https://www.psychologytoday.com/us/basics/illusory-truth-effect

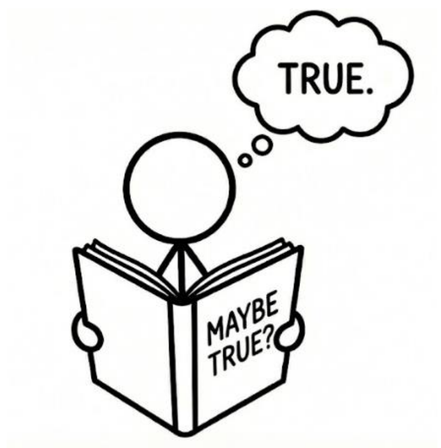


Belief is first, easy, and inexorable, whereas doubt is retroactive, difficult, and only occasionally successful.

Daniel Gilbert

‘You Can’t Not Believe Everything You Read’

DSP



Implications

1. In markets we are bombarded with research notes, tweets, and headlines, and because we usually just skim them, our brains treat what we understand as true unless we actively stop and question it.
2. The same bullish or bearish lines get repeated across brokers, media, and social feeds, and that repetition makes the story feel familiar & it increases our conviction, even if nothing new has been learned.

Guardrails

1. Belief can be fine in other parts of life, but in investing your default stance should be skepticism.
2. As you read, tag each claim as either supported by hard data or still just a hypothesis that needs testing.

Spinach was long treated as an iron superfood, and the cartoon sailor Popeye, whose strength famously came from a can of spinach, shows how deeply that belief had taken hold in popular culture.

A widely told story blames a 19th-century German chemist for a decimal point slip that made spinach's iron look ten times higher than it is, although the real problem was probably misreading data on dried spinach.

Later historians find no evidence for the decimal-point mistake itself: the catchy correction seems to have been popularized in the 1980s without checking original sources, then endlessly repeated. In the end, the debunking myth spread the same way as the original one did - by being read and repeated until it felt true.

Which "everyone knows" fact should you be questioning?

Illusion of Knowledge: Confidence & Accuracy

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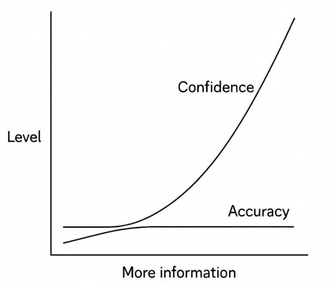
When people receive more information, their confidence grows faster than their accuracy. Oskamp's 1965 paper "Overconfidence in case study judgments" used the fictional patient Joseph Kidd. Clinical psychologists, graduate students and undergraduates read Kidd's life history in four installments. After each installment they answered the same multiple choice questions about his personality and rated how sure they were of each answer. Accuracy started only a little above chance and barely improved as more case detail arrived, while confidence climbed steadily with each new batch of information. By the final installment most judges felt highly certain about a picture of Kidd that was not supported by better test scores.

Hall, Ariss and Todorov's 2007 article "The illusion of knowledge: When more information reduces accuracy and increases confidence" moved to sports prediction. Participants predicted outcomes of National Basketball Association games. Across several experiments, some forecasters saw only simple performance statistics, while others saw richer information such as team names, which triggered background knowledge and loyalties. Intuitively, more information should improve prediction. In fact, added information often left accuracy unchanged or slightly worse, while pushing confidence noticeably higher and in some betting tasks reduced earnings. Together these studies show that additional variables and richer stories tend to inflate our feeling of understanding long before they improve our hit rate. Unless we actively track calibration, extra information is more likely to create an illusion of knowledge than genuine predictive power.

Read: https://home.csulb.edu/~cwallis/382/certainty/chapter19.html



A wealth of information creates a poverty of attention.

Herbet A. Simon

Illusion of Knowledge: Confidence & Accuracy

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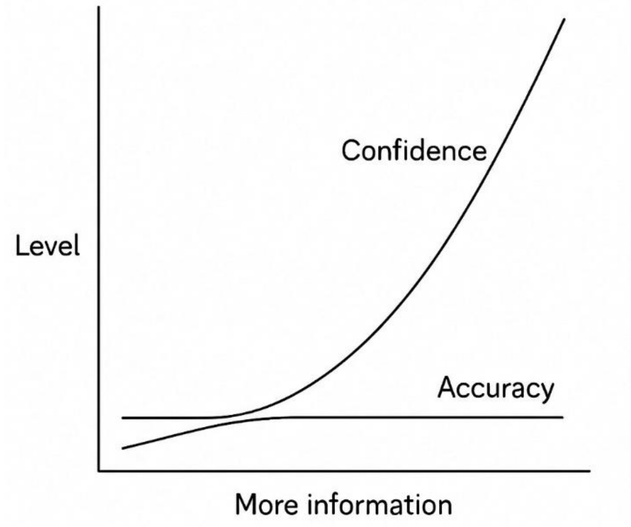

Implications

1. Research can be used subconsciously to justify an investment decision you have already made, rather than to test a hypothesis.
2. When many investors consume the same rich story, their confidence moves together. Correlations jump in stress & diversification benefits vanish when needed.

Guardrails

1. Treat strong conviction as a risk signal as well, not just a strength.
2. Separate information that truly changes value from information that just makes the story feel richer.
3. If many data points share the same source or underlying factor, count them as one.

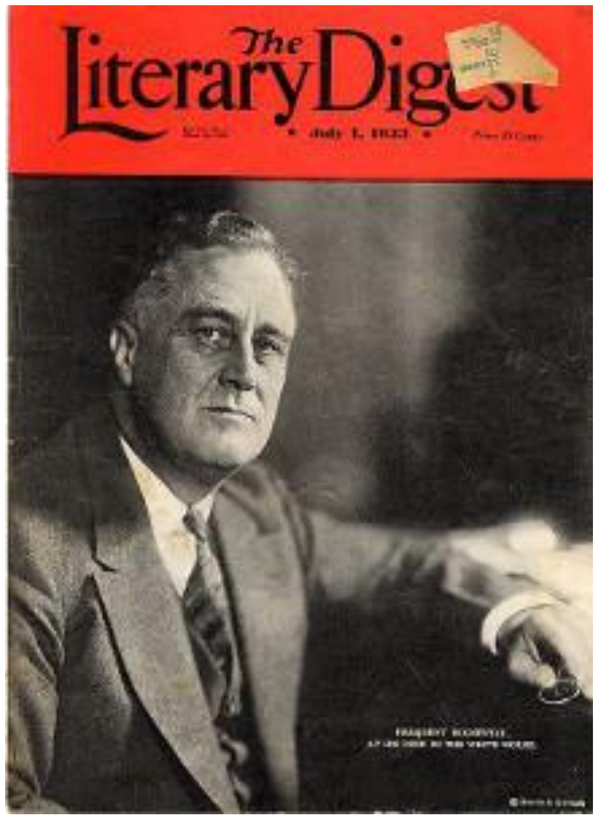

Image: https://mathcenter.oxford.emory.edu/site/math117/historicalBlunders/

In 1936, The Literary Digest was the king of political forecasting. Having correctly predicted every election for twenty years, they decided to go bigger than ever for the showdown between Franklin D. Roosevelt and Republican Alf Landon. They mailed out a staggering 10 million mock ballots the "Big Data" of its day.

With 2.4 million responses pouring in, the numbers seemed undeniable. The magazine confidently predicted a landslide victory for Landon. They even mocked a young upstart pollster named George Gallup, who surveyed just 50,000 people (a tiny fraction of their data) but insisted Roosevelt would win.

Roosevelt didn't just win, he obliterated Landon, taking 46 of 48 states. The Digest was wrong by a massive 19 percentage points.

How could 2.4 million people be wrong? The problem wasn't the size of the data, but the source. The magazine built its mailing list from telephone directories and car registrations. In the depths of the Great Depression, telephones and automobiles were luxuries. The Digest had accidentally polled only the wealthy, who overwhelmingly despised Roosevelt's economic policies.

Is our 'research' at times just a sophisticated way to justify the snap judgments we've already made?

Inequity Aversion: Capuchin Monkey Study

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In a well known series of experiments, researchers showed that capuchin monkeys respond strongly to unfair treatment, suggesting that a sense of fairness is not uniquely human but rooted in social evolution. When two monkeys performed the same simple task, both were content to receive cucumber slices as rewards. However, once one monkey began receiving a more desirable reward, such as grapes, while its partner still received cucumber, the disadvantaged monkey often reacted with visible frustration: rejecting the cucumber, throwing it back, or refusing to continue. This pattern implied that the animal was not just evaluating its own reward, but comparing it to what a peer received for the same effort.

Human economic games reveal similar patterns in a more formal way. In the Dictator Game, one person unilaterally decides how to split a sum of money with another, despite having no obligation, many dictators give away a non trivial share, implying that pure self interest is not the only motive. In the Ultimatum Game, one player proposes a split and the other can accept or reject; if the offer is rejected, both get nothing. People frequently reject low, “unfair” offers, sacrificing money to punish inequity. Across cultures, these experiments consistently show that individuals care about relative outcomes and norms of fairness, not just absolute payoff.

Watch: https://www.youtube.com/watch?v=meiU6TxysCg
https://www.pbslearningmedia.org/resource/nvsn6.sci.bio.dogs/do-dogs-understand-fairness/

A wealthy man is one who earns $100 a year more than his wife's sister's husband.

H. L. Mencken

Inequity Aversion: Capuchin Monkey Study

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Implications

1. You will care about how your returns compare to friends and benchmarks, so a decent absolute gain can feel "unfair" & push you to chase whatever is winning now driven by FOMO.
2. You may avoid good but "unfair" opportunities, such as buying into a great business after insiders have already made a fortune, even though your expected return from this point can still be attractive.

Guardrails

1. Anchor yourself to your own objectives, not other people's returns: write down a few concrete money goals and track progress against those.
2. Cut comparison fuel at the source by limiting financial social media and "how much did you make" conversations.
3. Write a short personal investment policy statement that fixes your target allocation, rebalancing rules and when you are allowed to trade etc.

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Air Rage & The Walk Of Shame

A 2016 study published in PNAS by researchers Katherine DeCelles and Michael Norton reveals that airplanes are not just vehicles, but flying pressure cookers of social hierarchy. Analyzing data from millions of flights, the researchers sought the root cause of "air rage" and discovered that physical inequality triggers conflict more reliably than lost luggage, tight legroom, or flight delays.

The study compared flights where Economy passengers boarded through a middle door (never seeing the premium cabin) versus those who had to perform a "walk of shame" through First Class. The results were stark: on flights where Economy passengers were forced to physically walk past the "grapes", wide leather seats and pre-flight champagne, incidents of unruly behaviour in the rear cabin increased by 2.18 times. The psychological impact of this visible inequality was calculated to be as enraging as a 9.5-hour flight delay.

Crucially, the toxicity flowed both ways. The study found that First Class passengers were also significantly more likely to act out when Economy passengers walked through their cabin, exhibiting "belligerent entitlement" to assert their threatened status.

If a simple curtain is all that separates calm from chaos, have we really evolved beyond the capuchin cage?

Read, Read, Read

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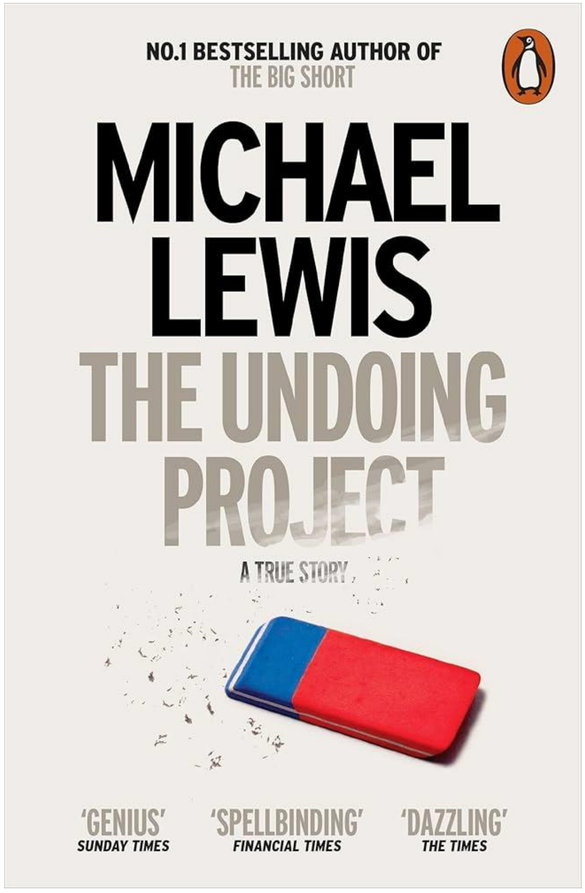
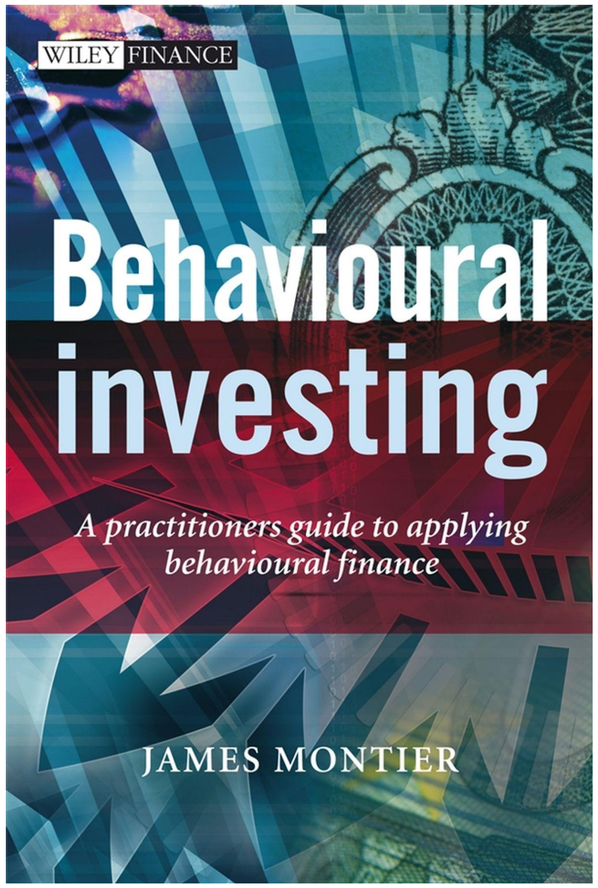
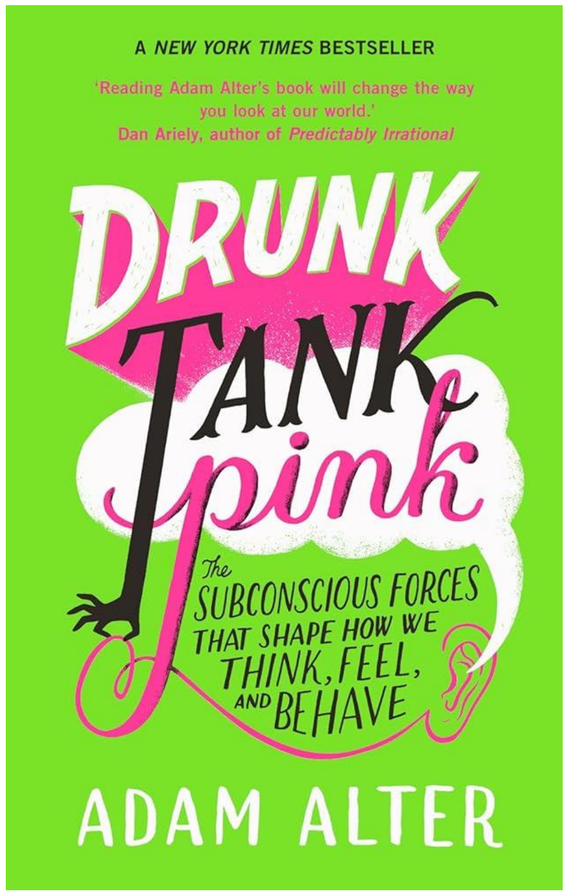






'A one-line intelligence test: The sooner you figure out that Amos is smarter than you are, the smarter you are'.

People think they choose by reason, but many choices are shaped by forces they do not see.

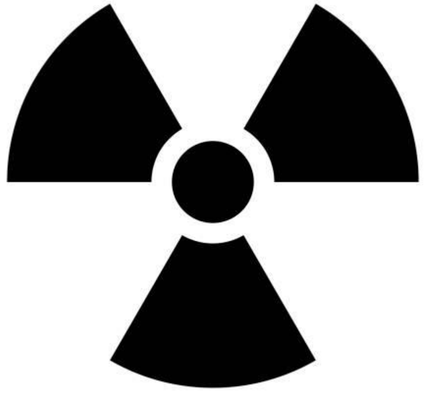
Undoing Project is packed with vivid stories about Kahneman and Tversky that quietly rewrite how you see judgment and risk. Behavioural Investing by James Montier is more like a coffee table field guide for investors, easy to dip into for charts, checklists and sharp rants about our money mistakes. Drunk Tank Pink is the odd one in the trio, a tour of strange experiments about color, names and tiny cues that push our behaviour in directions we never notice.

All three leave you watching your decisions.

NOBODY KNOWS…

The odds of a meltdown are 1 in 10,000 years.

Vitali Skylarov, Minister of Power and Electrification, Ukrainian SSR,
(two months before the Chernobyl accident)



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