

Koppel, Robert – Investing and the Irrational Mind

McGraw-Hill, 2011, [*Behavioural Finance*] Grade ★★★★★

A system with a proven edge and good money management practices are necessary but not sufficient for someone to succeed in trading. The decisive factor is the trader's psychological fortitude. Robert Koppel is a former commodities trader and hedge fund partner who has written several books on trading psychology. In this book he uses academic research within behavioural finance and neurofinance to back up his previously experience based conclusions.

The purpose of the book is to help the reader to break free from the psychological mechanisms that reinforce various investing fallacies. "The solution begins with awareness, leading to cognitive and emotional strategies that reinterpret our market experience through language, belief, feelings, meaning, and action." In my meaning Koppel does a great job with the first step – awareness – but gives the reader too little guidance on how to establish "bias resistant" strategies and processes. Awareness of psychological biases is not enough as it is very hard to imagine away reflexive mental processes. Knowing yourself does not guarantee that you can take that second step by yourself. The book is rescued by the depth and breadth of the author's knowledge when it comes to the subjects he's presenting.

The two most interesting and novel topics to me were the research presented when it comes to intuition and to what's called Theory of Mind. I've often found traders public opinions on intuition a bit too romanticized – seriously, how often do we want to read about George Soro's back aches? Intuition, as the author presents it, is a sort of pattern matching process that enables an investor to quickly reach a course of action. Intuition is facilitated by mental models built by knowledge and long experience. The more complex and unclear a situation is the more valuable is intuition.

Interestingly the solutions have sometimes been found to be triggered by physical cues (back aches...). This presents a dilemma; our mind shows limited rationality and we are subject to lots of psychological fallacies and yet when we ignore the intuition of the seasoned investment professional, performance is shown to go down. How does one build a process that protects against biases, keeps a rational analysis in various situations and which also allows intuition to tip the scales? Koppel proposes that intuition is used to generate investment ideas and that research is used as a second step. The order probably depends on what investment style the investor uses in general.

Theory of Mind (ToM) is the ability to recognize and understand the emotions and state of mind of other investors. With the ability comes the chance of predicting the action of other investors. This ability depends on both a strong awareness of oneself and of the market. ToM connects nicely to Andrew Lo's adaptive market theory. In a market of constant adaptive change the investor who can read the emotions of others has a distinct advantage. Koppel also presents research that finds a positive correlation between a highly developed ability to read other's state of mind and trading results. "Trading is essentially a social activity" as one of the researchers puts it.

This is a book that lacks a sense of direction. Just as a trader needs a system a book needs a structure. The chapters that are stacked on one another are mostly listings of various erroneous behaviors and it feels like the author's joy in having found scientific backing to his past experiences has prevented him from focusing on what he wants to put forth. The text is too much a random selection of facts about behavioral finance mixed with a dose of trading smartness. Luckily, the facts are interesting and Koppel is well read.

Mats Larsson, August 12, 2012