

## Chapter One



# In the Heat of the Moment



*Prepare, Plan, and Pre-Commit  
to a Strategy*

EMOTIONAL TIME TRAVEL ISN'T OUR SPECIES' FORTE. When asked in the cold light of day how we will behave in the future, we turn out to be very bad at imagining how we will act in the heat of the moment. This inability to predict our own future behavior under emotional strain is called an empathy gap.

We all encounter empathy gaps. For instance, just after eating a large meal, you can't imagine ever being hungry again. Similarly, you should never do the supermarket shopping while hungry, as you will overbuy.

Now let's imagine you are lost in some woods. As you search through your backpack you discover that you have forgotten to bring both food and water. Oh, the horror. Which would you regret more: not bringing the food or the water?

Psychologists\* have asked exactly this question of two different groups and offered them a bottle of water in return for participating. One group was asked just before they started to work out at a gym; the other group was asked immediately after a workout. If people are good emotional time travellers, the timing of the questions should have no impact at all. However, this isn't the pattern uncovered by the researchers. Sixty-one percent of the people who were asked before the workout thought they would regret not taking water more. However, after the workout, 92 percent said they would regret not taking water more!

My all-time favourite example of an empathy gap comes from an experiment by my friend Dan Ariely and his

\*L. Van Boven and G. Loewenstein, "Projection of Transient Drive States," *Personality and Social Psychology Bulletin* 29 (2003): 1159–1168.

co-author George Loewenstein.\* They asked 35 men (and it had to be men for reasons that will become all too obvious) to look at pictures of sexual stimuli on a cling-film-wrapped laptop. To save the gentle readers' blushes I have omitted the full list, but suffice it to say that acts such as spanking and bondage were included.

The subjects were asked to rate how much they would enjoy each act while in a cold state (in front of an experimenter in a classroom-like environment). The participants were then sent home and asked to reevaluate the pictures in the privacy of their own home while enjoying what might be delicately described as self-gratification.

In the cold light of day the average arousal rating was 35 percent. However, this rocketed to 52 percent when the men assessed the images in a private, aroused state. That is a massive 17 percentage point increase, driven by the heat of the moment!

### The Perils of Procrastination

In order to see how we can combat empathy gaps, we must first look at the perils of procrastination—that dreadful urge you suffer, when you know there is work to be done, to put it off for as long as possible.

\*Dan Ariely and George Loewenstein, "The Heat of the Moment: The Effect of Sexual Arousal on Sexual Decision Making," *Journal of Behavioral Decision Making* 19 (2006): 87–98.

Imagine you have been hired as a proofreader for a set of essays, each about 10 pages long. You have three options: You can set your own deadlines and turn in each essay separately; you can hand everything in at the last minute before a final deadline; or you can go with a predetermined set of deadlines for each essay. Which would you choose?

Most people (myself included, of course) go with handing everything in at the last moment. After all, we reason, I'll do the work at my pace and then hand it all in whenever I like.

Unfortunately, this decision ignores our tendency to procrastinate (something book editors will be all too familiar with!). While we all start off with the best of intentions to space out the work evenly, inevitably other things come up, our best-laid plans are disrupted, and we end up doing all the work at the last minute.

Yet, psychologists have found\* that imposed deadlines are the most effective. Researchers split people into three groups randomly and assigned them one of the conditions outlined above. Those who were told they had to follow equally spaced deadlines found the most errors, yet handed their work in with the least delay. The group who chose their own set of deadlines found fewer errors and were nearly twice as late

\*Dan Ariely and Klaus Wertenbroch, "Procrastination, Deadlines, and Performance: Self-Control by Precommitment," *Psychological Science* 13 (2002): 219–224.

handing in their reports. However, the worst-performing group was those who were allowed to wait until the final deadline to hand everything in. This group found far fewer errors than the other two groups and were nearly three times later in handing in their reports than those who worked to equally spaced deadlines. This experiment provides a possible weapon to place in our arsenal against the behavioral pitfall of empathy gaps and procrastination—pre-commitment.

### The Power of Pre-Commitment

So what can we, as investors, do to prevent ourselves from falling into these emotional time travel pitfalls? One simple answer is to prepare and pre-commit. Investors should learn to follow the seven P's—: Perfect planning and preparation prevent piss poor performance. That is to say, we should do our investment research when we are in a cold, rational state—and when nothing much is happening in the markets—and then pre-commit to following our own analysis and prepared action steps.

Sir John Templeton, legendary investor and mutual fund pioneer, provides us with a perfect example of this process in action. He was well known for saying “The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.” Few would disagree with the sentiment. However, when “everyone is busy despondently selling,” it can be hard to

stand against the tide and buy. This difficulty is the very definition of an empathy gap.

Sir John's great-niece, Lauren C. Templeton, provides us with the strategy her uncle used to overcome this obstacle in her book, *Investing the Templeton Way*:

There are clear psychological challenges to maintaining a clear head during a sharp sell off. One way Uncle John used to handle this was to make his buy decisions well before a sell off occurred. During his years managing the Templeton Funds, he always kept a "wish list" of securities representing companies that he believed were well run but priced too high . . . he often had standing orders with his brokers to purchase those wish list stocks if for some reason the market sold off enough to drag their prices down to levels at which he considered them a bargain.

This prime example of pre-commitment in the face of a known empathy gap is exactly what you should seek to emulate in your investment strategies. Sir John knew that on the day the market or stock was down say 40 percent he wouldn't have the discipline to execute a buy. But, by placing buy orders well below the market price, it becomes easier to buy when faced with despondent selling. This is a simple but highly effective way of removing emotion from the situation.