

This is the third part of the article on Zurich Axioms, the first of which appeared on Aug 12, 2011 and the second appeared on Aug 26, 2011

(A lot of these axioms are contrary to traditional thinking of investment gurus. While one may agree or disagree with these, it is a good idea to go through them and their rationale)

**Minor Axiom V
Beware the Historian's Trap.**

The Historian's Trap is a particular kind of orderly illusion. It is based on the age old but entirely unwarranted belief that history repeats itself. People who hold this belief -- which is to say perhaps ninety-nine out of every hundred people on earth -- believe as a corollary proposition that the orderly repetition of history allows for accurate forecasting in certain situations.

It is true that history repeats itself sometimes, but most often it doesn't, and in any case it never does so in a reliable enough way that you can prudently bet money on it.

Formulas can be wrong, but markets never are. The market does what it does. It makes no predictions and offers no promises. It just is. Arguing with it is like standing in a blizzard and howling that it wasn't supposed to arrive until tomorrow.

**Minor Axiom VI
Beware the Chartist's Illusion.**

Representing numbers by lines on graph paper can be useful or dangerous. It is useful when it helps you visualize something with greater clarity than you could achieve with numbers alone. It is dangerous when it makes the thing represented look more solid and portentous than it really is.

Making charts of stock prices is like making charts of ocean froth. You'll see each pattern once, and then it will be gone. Only by blind chance will you ever see it again. If you do see it again it will have no significance, for it predicts nothing. A chart line always has a comfortingly orderly look, even when what it depicts is chaos. Life never happens in a straight line. Any adult knows this. But we can too easily be hypnotized into forgetting it when contemplating a chart.

**Minor Axiom VII
Beware the Correlation and Causality Delusions.**

It is characteristic of even the most rational minds to perceive links of cause and effect where none exist. When we have to, we invent them. The human mind is an order-seeking organ. It is uncomfortable with chaos and will retreat from reality into fantasy if that is the only way it can sort things out to its satisfaction. Thus, when two or more events occur in close proximity, we insist on constructing elaborate causal links between them because that makes us comfortable. It can also make us vulnerable, but we don't usually think of that until it is too late.

Unless you can actually see a cause operating, really see it; regard all causal hypotheses with the greatest skepticism. When you observe events happening together or in tandem, assume that the proximity results from chance factors unless you have hard evidence to the contrary. Always remember that you are dealing with chaos and conduct your affairs accordingly. As the Axiom says, chaos is not dangerous until it begins to look orderly. Because so many people in the money world are so desperately seeking orderly patterns, places like Wall Street generate steady streams of ideas about possible causal links between this and that. Some of these postulated links seem plausible to many, others only to a few. But all of them have some kind of allure for that order-loving organ the human mind, and every one of them probably has meant trouble for somebody.

Guard against imagining causes when you can't actually observe them at work, and you will save yourself a lot of grief

**Minor Axiom VIII
Beware the Gambler's Fallacy.**

Says the gambler: "I'm hot tonight!" Says the lottery-ticket buyer: "This is my lucky day!" Both are working themselves into a state of expectant euphoria in which they will put money at risk with less than their normal prudence. Both are likely to be sorry.

When you say you are "hot," or you get the feeling that today is your lucky day, what you mean is that you are temporarily in a state in which random events will be influenced in your favor. In a disorderly world, with events whirling wildly around in all directions, you are a calm island of order. Events in your vicinity will stop the horseplay and obediently march to your tune.

Please read important disclosures on the last page

As we learned in our studies of the Second Axiom, countless speculators and gamblers have been bankrupted by failing to quit while they were ahead. The Gambler's Fallacy tends to encourage that failure, for it engenders the feeling that one is temporarily invincible. That is a dangerous feeling to have. Nobody is invincible, not even for half a second.

Speculative Strategy:

Now let's see specifically how the Fifth Axiom advises you to handle your money.

The Axiom warns you not to see order where order does not exist. This doesn't mean you should despair of ever finding an advantageous bet or a promising investment. On the contrary, you should study the speculative medium in which you are interested -- the poker table, the art world, whatever it is -- and when you see something that looks good, take your best shot. But don't be hypnotized by an illusion of order. Your studying may have improved the odds in your favor, but you still cannot ignore the overwhelmingly large role of chance in the venture. It is unlikely that your studying has created a sure thing for you or even a nearly sure thing. You are still dealing with chaos. As long as you remain keenly alert to that fact, you can keep yourself from getting hurt.

Your internal monologue should go like this: "Okay, I've done my homework as well as I know how. I think this bet can pay off for me. But since I cannot see or control all the random events that will affect what happens to my money, I know that the chance of my being wrong is large. Therefore I will stay light on my feet, ready to jump this way or that when whatever is going to happen happens." And that is the lesson of the Fifth Axiom. You are getting to be a smarter speculator all the time.

The Sixth Major Axiom

ON MOBILITY

Avoid putting down roots. They impede motion.

It is certainly nice in many ways to have roots. To feel you belong in some familiar place amid old friends and good neighbors: this can bring a glow to the heart. The opposites of this cozy situation -- rootlessness, a state of drifting, alienation -- seem cold and uncomfortable by comparison. Undoubtedly that is why most shrinkers believe we ought to have roots.

But you should approach this roots business warily. If you let it impinge on your financial life, it can cost you a lot of money. The more earnestly you seek that feeling of being surrounded by the old, the familiar, and the comfortable, the less successful you are likely to be as a speculator.

What the Axiom means more than anything else is a state of mind, a way of thinking, a habitual method of organizing your life. The message comes in two halves, each covered by a minor axiom.

Minor Axiom IX

Do not become trapped in a souring venture because of sentiments like loyalty and nostalgia.

There are times when you have to choose between roots and money. If you are interested in money -- which is presumably why you are studying speculation -- it is a mistake to let yourself get too attached to any physical thing in which your capital is invested. Get attached to people, but not to houses or neighbor hoods. Not to companies, either. You never know when it may be wise to sell out. Be sure you don't let roots impede you.

Minor Axiom X

Never hesitate to abandon a venture if something more attractive comes into view.

There are many ways in which you can get rooted in a speculative medium, to the detriment of your overriding goal of making money. One of the most common -- it sneaks up and takes people by surprise -- is to get into a situation in which you aren't sure whether you are conducting a speculation or a hobby.

Another common way to get rooted is to get into a situation in which you are waiting for something to pay off. This may happen to even more people than the speculation/hobby dilemma. It is possible to get trapped in a waiting game for years, while dozens of other good speculative opportunities drift tantalizingly within reach of your fingers, which are powerless to grasp them. Never get rooted in an investment because of the feeling that it "owes" you something -- or, just as bad, the feeling that you "owe" it enough time to show what it can do. If it isn't going anywhere and you see something better, change trains.

Of course, there is the possibility of regret, which we've studied under other Axioms. But the possibility of regret will also exist if you don't switch. Since the possibility of regret is the same no matter what you do, you might as well leave it out of the calculation. It is self-canceling. The decision to stay or switch should ride solely on the question of which speculation, in your judgment, seems to offer the best promise for a speedy payoff.

Please read important disclosures on the last page

Speculative Strategy:

The Sixth Axiom urges you to preserve your mobility. It warns against the many things that can get you rooted, to the detriment of your speculative career: sentiments like loyalty, hangups like the wish to wait around for a payoff. It says you must stay footloose, ready to jump away from trouble or seize opportunities quickly.

This doesn't mean you have to bounce from one speculation to another like a Ping-Pong ball. All your moves should be made only after careful assessment of the odds for and against, and no move should be made for trivial reasons. But when a venture is clearly souring, or when something clearly more promising comes into view, then you must sever those roots and go.

Be careful. Don't let those roots grow too thick to cut.

The Seventh Major Axiom

ON INTUITION

A hunch can be trusted if it can be explained.

A hunch is a piece of feeling-stuff. It is a mysterious little clump of not quite knowledge: a mental event that feels something like knowledge but doesn't feel perfectly trustworthy. As a speculator you are likely to be hit by hunches frequently. Some will be strong and insistent. What should you do about them? Learn to use them, if you can.

That is easy advice to give but, as you will undoubtedly discover, not so easy to carry out. The subject of intuition is complicated, imperfectly understood, and troublesome to many people. There are three distinct approaches to the phenomenon:

- **Scorn.** Many investor/speculators studiously ignore their own hunches and laugh at other people's. They insist on backing all speculative moves with facts and factlike material.
- **Indiscriminate trust.** Then there are people who lean on hunches too hard, too often, and without enough skepticism. Any wayward intuition becomes a reason for making a move, even when a rational analysis of the situation might yield completely different ideas.
- **Discriminating use.** This is the Zurich approach. The thought behind it is that intuition can be useful. It seems a shame to scorn such a potentially valuable speculative tool in a categorical way -- to throw out all hunches just because some are silly. On the other hand, it is true that some hunches deserve to be tossed in the garbage can. The challenge is to discern which are worthy of your attention and which are not.

You take in colossal amounts of data every day – vastly more than you can store in your conscious mind and recall in the form of discrete data bits. Most of it is stored in some other reservoir just below or behind the conscious level. A good hunch is something that you know, but you don't know how you know it.

We are now in a position to understand what the Seventh Axiom means when it says, "A hunch can be trusted if it can be explained." When a hunch hits you, the first thing to do is ask whether a big enough library of data could exist in your mind to have generated that hunch. Though you don't know and can't know precisely what the relevant data bits might be, is it plausible to think they exist?

The reason for subjecting hunches to this rigorous testing is that sometimes we get flashes of intuition that aren't based on good, hard fact. They are airy nothings. Even the most solid-based hunch can be wrong. Conversely, an out-of-nowhere hunch can be right, just as any wild guess can. What this procedure does for you is to improve the odds in your favor. It puts you one up on those who scorn all intuition and also on those who think all hunches are sent from heaven.

No matter how good a hunch feels, don't let it lull you into a state of overconfidence. Stay worried.

Minor Axiom XI

Never confuse a hunch with a hope.

When you want something very much, you can all too easily talk yourself into believing it will happen. This fact of human psychology confounds little children dreaming of what they want for Christmas, and it confounds speculators dreaming of all the money they're going to make.

My personal rule is to be highly skeptical anytime I have a hunch that something I want to happen will happen. This doesn't mean all such hunches are wrong. It means only that one should examine them with extra care and double one's guard in case of trouble. By contrast, I'm much more inclined to trust an intuition pointing to some outcome I don't want.

Speculative Strategy:

The Seventh Axiom suggests that it is a mistake either to laugh at hunches categorically or to trust them indiscriminately. Though intuition is not infallible, it can be a useful speculative tool if handled with care and skepticism. There is nothing magical or otherworldly

Please read important disclosures on the last page

about intuition. It is simply a manifestation of a perfectly ordinary mental experience: that of knowing something without knowing how one knows it.

If you are hit by a strong hunch telling you to make a certain move with your money, the Axiom urges you to put it to a test. Trust it only if you can explain it -- that is, only if you can identify within your mind a stored body of information out of which that hunch might reasonably be supposed to have arisen. If you have no such library of data, disregard the hunch.

The associated Minor Axiom XI warns, finally, that a hunch can easily be confused with a hope. Be especially wary of any intuitive flash that seems to promise some outcome you want badly.

HDFC Securities Limited, I Think Techno Campus, Bulding –B, "Alpha", Office Floor 8, Near Kanjurmarg Station,
Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Fax: (022) 30753435

Disclaimer: This document has been prepared by HDFC Securities Limited and is meant for sole use by the recipient and not for circulation. This document is not to be reported or copied or made available to others. It should not be considered to be taken as an offer to sell or a solicitation to buy any security. The information contained herein is from sources believed reliable. We do not represent that it is accurate or complete and it should not be relied upon as such. We may have from time to time positions or options on, and buy and sell securities referred to herein. We may from time to time solicit from, or perform investment banking, or other services for, any company mentioned in this document. This report is intended for Retail Clients only and not for any other category of clients, including, but not limited to, Institutional Clients

Please read important disclosures on the last page