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Good Framing Shortcuts Can Help Avoid Costly Framing Errors

ACADEMIC PERSPECTIVE

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"If you have been in a poker game for a while, and you still don't know who the patsy is, you're the patsy." Vanessa Selbst, the most successful woman player in the history of professional poker, needs no reminding of this old framing lesson. Instead, she uses it in her new work as a senior investment associate at the world's largest hedge fund, Bridgewater Associates.[1]

We use framing shortcuts when we simplify complex problems and substitute solutions to the simplified problems for solutions to the complex problems. We use framing shortcuts well when solutions to the simplified problems are close to the solutions to the complex problems. We commit framing errors when solutions to the simplified problems are far from the solutions to the complex problems. Awareness of framing errors is the first step to correcting them. Financial advisers serve their clients well when they guide them to good framing shortcuts and away from costly framing errors.

FRAMING POKER GAMES

Selbst correctly frames poker games as zero-sum games. All the money on the poker table comes from the players' pockets. If some walk away from the table with winnings, others must walk away with losses. The sum of winnings and losses must equal zero.

Based on that experience, she also frames financial-market trading games correctly: "If something's undervalued, does that mean you want to buy? Well, maybe, but if you buy it, how's it going to go up? Who are the other people who are going to buy? ... You have to be thinking about who the other players are and what they're going to do."

Framing poker games correctly as zero-sum games is easy. Each player sees all the other players across the poker table, and it is obvious to everyone that all the money on the poker table comes from the players' pockets.

FRAMING FINANCIAL-MARKET TRADING GAMES

Framing financial-market trading games as equivalents of poker games is a simplifying framing shortcut. But this shortcut can quickly turn into a framing error because financial-market trading games are market-sum games yet are often described inaccurately as zero-sum games. Moreover, financial-market trading games are more complex than poker games because traders do not see each other.

Knowledgeable traders frame financial-market trading games correctly as market-sum games. The market return of a financial market, such as a stock market, is rarely zero. Instead, it is usually positive or negative. Financial-market trading games are market-sum games because the sum of the gains and losses of traders must equal the market return. Traders are correct when they object to the description of financial-market trading games as zero-sum games, noting that all traders can collect positive returns when market returns are positive. Yet, not all traders can be winners. If some traders are winners, collecting returns exceeding market returns, other traders must be losers, collecting returns short of market returns.

FRAMING SHORTCUTS AND FRAMING ERRORS

In a parallel thought, poker players with above-average skills can still be patsies in games where the skills of some other players are much above average. Indeed, it is possible that the top 1% of poker players, such as Selbst, walk away with great winnings, and almost all other players, even those with above-average skills, walk away with losses.

As in poker, traders with above-average skills are not assured of winning, walking away with above-market returns. Instead, it is possible that the top 1% of traders, those with the best skills or information, garner returns much higher than market returns, and all other traders, even those with above-average skills or information, garner below-market returns.

Amateur investors often lack financial facts and human behavior knowledge, misleading them into framing errors as they apply framing shortcuts. We see these framing errors in some reader responses to my 2017 true-or-false quiz in The Wall Street Journal.[2] Consider the following statement: “A surgeon perfects her surgeries and increases her rate of success as she performs surgeries more often. Likewise, an investor perfects his trading and increases his rate of success as he trades more often.”

I chose false as my answer, describing those who chose true as misled by framing errors. I wrote: “The analogy between a trader and a surgeon is one that many investors make. It makes intuitive sense. But it is wrong. The human body doesn’t ‘compete’ with the surgeon as she perfects her surgeries; it doesn’t switch the heart from left to right. But two traders on the opposite side of a trade compete with each other. A trader might perfect his skills by frequent trading but will nevertheless lose if the other trader has greater skills or possesses better information.”

Some readers found it difficult to comprehend the correct frame for trading because it differs from correct frames in familiar settings, such as surgery. One reader wrote: “If I make investments in the stock market, I do not have to be better than a professional analyst to make money. Any improvements I make in those decisions has nothing to do with them.”

Amateur traders can be lucky from time to time, beating professional analysts. But amateur traders likely lose more often than they win. Indeed, a study by Brad Barber and Terrance Odean found that the returns of investors who trade frequently lag those of index investors by as much as 7 percentage points.[3]

Financial advisers possess financial facts and human behavior knowledge, including information about framing shortcuts and errors. They serve their clients well when they share that framing knowledge with their clients, guiding them to good framing shortcuts and away from costly framing errors.

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Endnotes

[1] Friess, S. (2018, July 27). From the Poker Table to Wall Street. *The New York Times*.

[2] Statman, M. (2018, October 23). A Different Kind of Financial Literacy Test. *The Wall Street Journal*.

[3] Barber, B. M., & Odean, T. (2000). Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors. *The Journal of Finance*, 773-806.