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### ***"Cocaine Brain"***

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**To Focused Compounding members:**

One of the most interesting moments in investing is when you find a stock idea that seems too good to be true. Something that makes you drop everything you are working on now and focus on it instead. In Atul Gawande's *"Checklist Manifesto"*, Guy Spier (the author of the amazingly honest *"The Education of a Value Investor"*) referred to this moment as the onset of "cocaine brain." In *The Checklist Manifesto*, Mohnish Pabrai says it was his desire to cure himself of this cocaine brain that caused him to start using an investing checklist:

*"...he believes the mistakes happened because he wasn't able to damp down cocaine brain...no matter how objective he tried to be about a potentially exciting investment...he found his brain working against him, latching onto evidence that confirmed his initial hunch and dismissing the signs of a downside. It's what the brain does."*

We all know this happens. But, why does it happen? And why does it happen with some stocks and not others?

In that quote from *The Checklist Manifesto*, Atul Gawande uses the phrase "potentially exciting investment". It's that second word we need to worry about. As stock pickers, we deal in "potentials" all the time. And solid long-term investments don't really seem to be what triggers "cocaine brain". What does? Something "exciting". A quick buck. The two factors that seem most important in triggering cocaine brain are the size of the expected payoff (big) and the timing (soon). If you found a mispricing where you could go long one stock and short another and make 30% to 50% over the next 1 to 3 years – I don't think that would trigger cocaine brain. That's a 9% to 50% annual return in what might be close to a risk-free operation. On the numbers, it should qualify as an "exciting" investment. But, it doesn't get the pulse racing. If you knew for sure you wouldn't be making any of this money in less than a year and it might very well take you 3 years – that wouldn't trigger cocaine brain. Now, imagine the same situation. But, imagine this arbitrage profit can be made in 1 to 3 weeks. That obviously makes the annualized profit huge. But, it does more than that. It makes the payoff seem very close, very immediate.

The value investors I know tend to experience cocaine brain more when looking at an unbelievably cheap stock rather than when looking at a great business. Even some of the greatest businesses out there are unlikely to consistently compound at much more than 20% a year. So, the payoff may be very big in the long-run (decades), but it's nothing like a cheap stock (which always feels like it can pay off in days). A cheap stock can triple this year. That's what sets off cocaine brain.

**To learn about our managed accounts, email Andrew at [info@focusedcompounding.com](mailto:info@focusedcompounding.com) or call or text him at 469-207-5844.**