When bias clouds investment thinking

Research on investment markets has changed a lot over the past 70 years. It seems strange now but, prior to the 1970s, very little research was directed to how investors made decisions. The reason is relatively simple: early researchers like Harry Markowitz from the University of Chicago believed that when putting money at risk, investors would always act rationally. Early researchers believed this despite the plentiful (albeit likely anecdotal) examples of human beings acting irrationally. This change in view from investors as rational decision-makers to imperfect participants has taken the investment world by storm over the past four decades. As a result, the 2002 Nobel Prize in Economics was awarded to psychologist Daniel Kahneman, who pioneered research on human beings making irrational decisions.

In this quarter's *Optimist*, we discuss

- why understanding behavioral finance is important;
- go into detail on two notable biases and how they challenge our investment abilities; and
- advise on ways to recognize and deal with these challenges.

Decision shortcuts

What comprises 2% of our weight, but devours 20% of our energy?[2] Our hungriest organ is not our stomach, but our brain. As a result, short cuts are often used by the brain to conserve energy and make life easier. If you have ever done the 'blind spot eye trick' as a child where you mark a cross and a dot on a piece of paper, then cover your left eye and stare at the cross with your right eye while slowly moving toward the paper, only to find that the dot disappears[3], you have experienced your brain's attempt to fill in a blind spot.

A similar, involuntary process can happen with decision-making in the form of cognitive bias. Because decision-making takes so much energy, we systematically filter information through our previous likes, dislikes, culture and personal history to make the process easier. This can lead to judgments based on inaccurate information and perception. More importantly, these judgment blind spots are naturally occurring and experienced by all of us.

Bias affects everyone (and we don't even know it)

In a study published in *Management Science*, a journal looking at the science of organizational management, researchers found almost all participants were affected by a blind spot towards their own bias. In addition,

they found the blind spot had no relation to aspects of personality, such as intellect or self-esteem, and individuals tended to underweight the magnitude of their own bias. According to Carey Morewedge, associate professor at Boston University, "whether a good decision-maker or a bad one, everyone thinks that they are less biased than their peers"[4].

Confirmation Bias

Confirmation bias occurs when people look for evidence to reinforce their own beliefs and discredit evidence that opposes those views. As we sit down to read our morning paper, it is hard not to skip over articles about places with which we have no familiarity, or political opinions that differ from ours. The newspapers, magazines and television programing we seek out and consume likely will be filled with thoughts and opinions that fit our own. In addition, it is likely that we underestimate the degree to which this type of confirmation occurs.

There are few more obvious examples than the controversy that occurred in the 1990s when vaccines were connected to autism. Despite the original research being proven fraudulent and the doctor who published the research found guilty of professional misconduct and removed from the U.K. medical register, it is possible to find concerned parents who have lost faith in the medical system still questioning the safety of the measles, mumps, and rubella vaccines[5]. While this may seem like an extreme example, confirmation bias is just as common in areas such as politics and investing. Once a seemingly good idea has wormed its way into our brain, we naturally start reducing the available information that we are processing. Think the markets are over-valued? Your attention will likely be grabbed by news supporting the same belief and ignore news to the contrary, and vice versa.

Hindsight bias

To some investors, the bursting of the Dot Com Bubble in 1999 and the Subprime Mortgage Bubble in 2008 seem incredibly obvious. Movies and books like *The Big Short* make us wonder why more people did not see these issues coming. More recently, the Canadian dollar has risen over 10% in a matter of months, settling in above 80 cents versus the U.S. dollar. This too may seem like an obvious trend as oil is no longer trading at $35 per barrel and the Bank of Canada is raising interest rates. Yet, less than nine months ago, headlines like "2017 could be a bad year for the Canadian dollar"[6] and "Canadian dollar could drop to 65 cents"[7] were running through Canadian media. Unfortunately, hindsight bias - the belief that previous events were predictable - has a way of making people forget past mistakes.[8]

Psychologist Baruch Fischhoff performed a study where participants were asked to predict the outcomes on a real-life event: Nixon's visits to China and the USSR. Fischhoff initially asked participants to predict events that would take place such as Nixon meeting Mao.[9] He then asked them to recall their earlier predictions at timed intervals from two weeks to six months later. Fischhoff found that the participants would not only consistently misremember their guesses, but would recollect them in a more positive light so they appeared more perceptive.[10]

"It's tough to make predictions, especially about the future"
~ Yogi Berra

Clearly, the combination of confirmation and hindsight bias can have profound effects on investors. One can easily imagine an investor finding information that confirms his or her viewpoint on a previous event, and overconfidently believe that this hindsight will provide foresight.

The first step to better decision-making is acknowledging that bias exists and is natural. Everyone has a bias blind spot. In fact, people who believe they have fewer biases than their peers show a greater likelihood to ignore advice from other people.[4] In that way, not recognizing one's own biases leads to less effective decision-making.

After recognizing the prevalence of bias, seeking out a second opinion can be beneficial in cutting through personal bias. In a 2016 report, Vanguard Research

estimated that about 50% of the impact of working with an investment advisor was connected to 'behavioral coaching'[11]. Setting up a structured approach with clear expectations, rebalancing investment portfolios mechanically and providing professional opinions on matters of personal finance aim to help investors mitigate the emotions and biases that drive poor investment decisions. In addition to a trusted financial advisor, an alternate opinion from a knowledgeable lawyer, accountant, business partner, spouse or friend can be invaluable.

Lastly, education can help. In this paper, we have highlighted just two of the more than 20 cognitive biases. In future newsletters and workshops, we will continue to highlight behavioral finance and its implications. Understanding the different types of biases and how they manifest in our thoughts and actions can help us watch out for them.

Conclusion

It is not only important to understand the concept of varying biases but to know that all human beings have an inherit bias in one form or another. As investors, it is important to recognize you may have a bias and to seek out advice that may differ from your own. By knowing that not all people act in a predictive way and tend to act based on biases, one can learn to make more knowledgeable decisions.

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Marshall McAlister, CFA
Private Wealth Counsellor, Principal

mmcalister@pavilioncorp.com

T: 780 638 2491

Cary Williams, CFP
Associate Private Wealth Counsellor

cwilliams@pavilioncorp.com

T: 780 638 2493