



Buttonwood's notebook  
Financial markets

## Investing

# The bias curse

May 9th 2014, 15:34 by Buttonwood

IN HIS erudite history of financial speculation, "Money Mania: Booms, Panics, and Busts From Ancient Rome To The Great Meltdown", Bob Swarup lists a whole set of behavioural biases to which we are all prey. Some of these will be familiar to readers but the full list might still be useful.

*Aversion to ambiguity.* We like sure things and do not like "Knightian uncertainty" - situations where (unlike roulette) the odds are unknown. This may lead us to mistake situations of genuine uncertainty (ie, most of the decisions we face in life and in investment) for those where the odds are more established. That prompts other biases on our list.

*Cognitive dissonance*, or the vegetarian who wears leather shoes. As Mr Swarup describes it

When faced with conflicting beliefs or ideas, we unconsciously try to reconcile the conflict and regain our equilibrium through distortion.

Perhaps expecting rapid economic growth and very low interest rates is a current example of this syndrome in action. This problem is closely related to the next problem which is

*Confirmation bias.* A very difficult problem to avoid, as your blogger can attest. If you have a particular world view, or an investment view, you tend to believe the facts that fit your thesis and discount those that don't. As you may have noticed, this blog tends to be a bit bearish; I try to control this bias through numbers. If valuations were below average, I would be bullish (honest). But that may lead me to discount analysis that shows the range of valuations has shifted.

*Extrapolation.* Placing more weight on recent events than on past ones. A lot of strategists tend to compare current valuations with those in the 1980s and 1990s; anything before 1950 is dismissed. At the individual stock level, extrapolation is a particular problem with growth stocks; their earnings grow fast, so the share price builds in future rapid gains. When the earnings falter, the stock suffers a double whammy.

*Framing.* Our answer to a question depends on how it is framed. Mr Swarup gives an interesting example; people are shown film of a car collision and asked to estimate the speed of the vehicles concerned. Ask "How fast were the cars going when they smashed into each other?" and the average guess will be higher than if you ask "How fast were they going when they bumped into each other?" I'm sure this plays a role when investors pick mutual fund names.

*Hedonic treadmill*, or the new car problem. We are never satisfied. You buy a new car and for a week it feels great but then it's just "the car". This leads to excessive fiddling with our portfolio (see loss/gain asymmetry below) and this trading diminishes returns.

*Hindsight bias*, or how I knew that Andy Murray would win Wimbledon. We make thousands of predictions in our lives - to ourselves or to others - and we remember the ones we got right, not the ones we got wrong. Nor is a vague feeling much proof of your superior intellect; you may have thought tech stocks were overvalued at the start of the year, but did you make any money out of it?

*Illusion of control.* Everything that goes right is down to our skill, whereas everything that goes wrong is down to bad luck. Again this leads us to trade too much and overestimate our ability, whereas sticking money in an index fund would save us time and money.

*Illusion of explanation or post hoc ergo propter hoc.* All financial journalists know this one. The market went up/down because the non-farm payrolls were better/worse than expected. Or perhaps a hedge fund was unwinding a loss-making position. But we don't know that detail so we attribute price movements to the information we do know. (Well, we've got to write *something*.)

*Loss/gain asymmetry*, or selling winners and letting losers ride. We don't like to admit we're wrong by taking a cash loss on a losing position. But we want to do something (see hedonic treadmill) so we take our profits elsewhere.

*Myopia or hyperbolic discounting.* We would rather have \$1000 now than \$1010 next year. We know we should be dieting but we eat that doughnut anyway. We don't save enough for our pensions as a consequence; what 25 year old wants to think about being 65?

*Overconfidence.* This is related to the illusion of control and hindsight biases described above. We are all better drivers than average and have a great sense of humour. But in macroeconomic terms, this trait is quite useful. Entrepreneurs overestimate their chances of success when starting a business but if they didn't fewer businesses would get started. Bloggers overestimate how many people will get to the end of each article but we keep going; otherwise all articles would end abrupt