FLEURUS INVESTMENT ADVISORY

February 22, 2015.

Emotionality and Investing (2)

In a prior note on this subject, I indicated how psychology had made significant contributions to the fields of finance and economics and facilitated the birth of a new discipline called Behavioral Finance.

I briefly described some of its findings such as **the anchoring effect**; the tendency to attach or "anchor" our thoughts to a reference point that may or not have any relevance to the decision at hand, or **the disposition effect**; the tendency to value losses and gains differently. I also suggested approaches that can be used to counter their potentially negative effect on our investment decisions. In a continuation of this process, here are three more concepts derived from this relatively new field of research.

The **confirmation bias** is the tendency to search for, interpret, or recall information in a way that confirms one's beliefs or hypotheses. People display this bias when they gather or remember information selectively, or when they interpret it in a biased way. One of the effects of confirmation bias is "belief perseverance", when beliefs persist after the evidence for them is shown to be false. Another one is "illusory correlation" when people falsely perceive an association between two events or situations. Applied to investing, this bias leads investors to focus on information that confirms their pre-existing thoughts and to minimize or ignore the rest.

The **availability bias** is the tendency to judge probabilities on the basis of how easily examples come to mind. An example of this bias is evidenced in the context of the lottery. Why do people play the lottery when the odds of winning are so infinitely small? Lottery organizers heavily promote the jackpot winners and as a result people are continually hearing about those who've won big. Consequently, people assume they are much more likely to win than they really are. Applied to investing, this leads investors to weigh the most recent or frequently repeated information more heavily than other information that may be more relevant to the decision at hand. Or it may lead them to dismiss or minimize information that is not easily available.

A final concept is that of **representativeness.** It refers to our tendency to infer the chance of an event occurring by comparing it to another event of similar nature, ignoring the laws of probability in the process. It is a mental process, akin to a rule

of thumb, that allows us to reach rapidly a decision under uncertainty. Often, an error of representativeness comes from our desire to spare our mental capacities and time. It can be costly

Suppose Company A has had a series of good quarterly earnings over the past two years. The good earnings may have come from a combination of exceptional strategic decisions five years ago, improving macro economic conditions and other specific circumstances that are not likely to endure. However, an investor may infer from this good earnings series that it will continue for another two years, ignoring in the process the probability that this set of causal events may have been exceptional. An investment under those circumstances could bring about painful consequences.

For my own practice, I have found a few ways to mitigate the confirmation, availability and representativeness biases. They include, respectively: 1) actively seeking and listening to dissenting opinions, 2) conducting careful and thorough research that goes beyond the review of the latest data releases, 3) maintaining discipline in one's investment research and analysis in order to avoid mental short cuts and major errors of probability. As simple as they are, these suggestions are difficult to implement on a sustained basis! There is however much to gain from their practice.

Jeff de Valdivia, CFA, CFP® is founder of Fleurus Investment Advisory, LLC - a registered investment advisor. Details on his firm can be found at www.fleurus-ia.com.