

# Availability Traps in Investing

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Life presents us with many situations in which we are called upon to make a decision, often without allowing us the luxury of having full information. This is known as decision making under conditions of uncertainty. Investing is a very good example for two general reasons:

1. The future is always unknowable. Nevertheless, there is no shortage of people who profess to be able to forecast the future, sometimes based on projections of the past and other times using arcane methods with no proven basis for reliability. Even well regarded experts may be of little help in divining the future. For example, how many of them warned of the impending global financial crisis in 2007?
2. There may be information available, but finding and assessing it is both time consuming and difficult for typical private investors, who lack education in investing and who are time poor.

What this means is that we should all seek to extend and improve our investment knowledge and our skills at finding and assessing information. This is likely to be an unending life-long task, which can be very rewarding in both money and satisfaction, but a great deal of time and effort is required. In effect, we need to train ourselves in a new profession that may be quite different to what we have already experienced at school and university and in the workforce.

## Heuristics

Instead of making every decision from scratch, we develop what psychologists call heuristics; devices we may recognise by the simpler name of rules of thumb. These rules are developed and refined progressively as we find things out by formal study or by life experiences.

In investing, some common heuristics might include only buying stocks with low price earnings ratios, high dividend yields and low debt to equity ratios. If these heuristics are solidly based in logic and validated by research into how they have worked in the past, these may be very valuable rules. They might be very powerful at least as an initial filter for drilling down to a short list of the best opportunities to choose from.

When we need to make a decision, we use these heuristics to make sense of difficult situations in which we have to make choices. We apply the heuristic to the limited information that is available. To the extent that our heuristic is closely reflecting reality, it will serve us well. However, most heuristics are imperfect, in that they are at best rough guidelines and do not stand up well in all situations. This opens us up to errors and biases in our decision-making.

## Availability Heuristic

One of the more pervasive rules of thumb is called the availability heuristic. The availability bias affects each of us every day, whether we realise it or not. The good news is that once we know how subject we all are to the availability bias we can start to deal with it consciously. The bad news is that continuing in ignorance of the availability bias can lead us to make very poor decisions, if not mistakes.

The availability bias is this: when called upon to make a judgement or express an opinion about something, we draw on our memory. We therefore rely for our judgement or opinion on those things that come to mind most readily from our memory. What comes to mind will depend on what we have been exposed to, our experience and knowledge, but also those things that are most recent or which made the most vivid impression on us.

## Joan's accident

Joan is a case in point; she was recently involved in a car accident involving a young person who was speeding. This left a strong impression on her because it was recent, happened to her personally and because she was emotionally affected by the accident. A week later she is still very timid about driving in traffic. When she meets with friends, or talks to them on the telephone, she relates to them what happened to her. This reinforces the strength of her memory of the event. Not surprisingly, when talking about the accident, she offers the opinion that young people cause most traffic accidents. This is the availability heuristic in action. Joan has drawn a conclusion from her own recent and vivid experience. The availability heuristic may well serve her well in that there may turn out to be a statistical basis for her conclusion. However, in many situations, the availability heuristic may cause her to reach altogether unwarranted conclusions.

We should not see the availability heuristic as only a negative bias. Much of the time, the availability heuristic will serve us well because events that occur frequently are more likely to be remembered than things that happen rarely. We are therefore able to quickly and accurately make good judgements and form useful opinions.

## The danger in availability

Nevertheless, reliance on the availability heuristic can play havoc on our ability to accurately assess how often something has happened in the past and, more importantly, the likelihood that it will occur in the future. This happens when we have very limited knowledge, such that we do not have a clear picture of the whole universe of possibilities. It can also happen when the subject is highly emotional, such that it has made an impression on our memory that is out of all reasonable proportion. A good example would be if we were personally involved in a traumatic situation compared to another situation we only read about in the newspaper.

My parents' generation was emotionally scarred by the great depression of the 1930s. They, or their parents, lost money in the great stock market crash and may have suffered years of unemployment and degrading work for the dole. Some never received the education they might have been able to afford in more normal times.

## Ernie's story

Ernie was in high school when he saw his father lose his savings in the stock market and then his business failed in the depression. Their family spent a decade eking out an existence as best they could. Ernie never forgot this and still today, all of his meagre savings are in government bonds and bank accounts. Clearly, this investment policy is driven by the availability heuristic and it has left him with a strategy that has seen him living off the pension, when he may have made far better use of his savings in providing for his retirement.

The sad part of this is that the first decade of the twenty first century has seen another dramatic fall in the stock market. Many people will have been badly hurt financially. They will be likely to be ultra-cautious in their investments for the rest of their lives and will pass that caution on to their children and will reinforce the opinions of their friends. The availability heuristic will have struck again. In their minds the next crash is just around the corner. Yet severe stock market crashes are neither common nor frequent: 1929, 1974, 1987 and, 2008. The sad part of the availability heuristic is that many of the people affected will invest going forward on the basis of one bad experience, which happens very rarely.

## Shares versus property

As we have just seen in Ernie's experience, investment is a fertile field for availability bias. One of the most common examples is the volatility of prices. We will all have heard the opinion that share prices are far more volatile than property prices. Sometimes this even takes the form of an assertion that share prices often fall, but property prices only ever go up. These assertions are based on the availability heuristic. There is an active, well reported, market in shares. Comparison is easy because all Telstra shares are the same no matter where the shareholder lives. We can see prices changing minute by minute on the internet and certainly we see reports of rises and falls in share prices every day on the television news, on the internet and in the newspaper. Against this,

property prices are far harder to come by and are reported infrequently, if at all, for long periods. Moreover, every house in every street is different, not to mention in different suburbs and different states. Comparisons are very difficult as anyone will know who has had to buy or sell a house. Some houses only sell once in a generation, so there is no reference point that allows any clear idea of their prices. Out of sight, out of mind is a saying that neatly sums up the availability bias.

As someone who spends a lot of time reading and researching shares, I have learned to recognise the availability bias in action all the time.

## Jason's tip

Someone asks for an opinion about a share. While I am weighing up the information in my memory, Jason, a tyro investor beats me to the punch with a strongly held view based on something Rebecca told him recently over a dinner in the local restaurant. When I question the basis for Rebecca's knowledge, I am told that she says that she heard it from another friend, whose father works for the company in the warehouse. I am immediately aware that the availability heuristic is staring me in the face. I ask a few more questions, which begins to irritate Jason, who then admits he has a large investment in the company on the basis of Rebecca's informed view.

Often, I may be reluctant to express a view at all because there is so much conflicting or vaguely remembered information available to me. I need to research the matter more thoroughly and assess it carefully before being confident to express a view.

The antidote to availability bias is to substitute research for memory. Be very wary about relying only on the most recent or most visible report about a share. Seek to form a rounded view based on the available facts. Be especially cautious when any situation looks to be an absolutely black and white case. There should always be positive and negative factors to weigh up, or we are in grave danger of becoming a victim of the availability heuristic.

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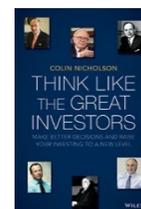
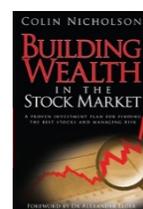
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