Four Common Errors and Biases

There are many reasons why investors may make less than optimal decisions.

Lack of knowledge is often the prime cause of beginners losing money, because they have waded deep into the market without stopping to study the textbooks, courses and seminars. Investing and trading is a profession which is practised by very well educated and intelligent professionals, who will often be on the other side of our trades.

Once we have the knowledge, we need to develop and test our investment or trading plan. This can be on past data and done by paper trading, which is a very useful method involving no loss of money. However, sooner or later, real experience is necessary using our savings in the market.

It takes many years to become a skilful investor. In my experience, ten years is around the time required and lines up well with the time needed to become proficient in most professions. The trick is to try not to lose too much money in this stage of developing skill and judgement from experience.

Beyond that, we venture into the area of psychology. In its broadest sense, this involves learning to master our own thinking patterns. All of us come to investing with similar natural impulses which cause us to make poor decisions. This happens because there are many errors and biases to which we all fall victim. This is critical for investors, because every new piece of information requires at least some level of analysis and a decision, even if that decision is simply to do nothing.

I recently read a review by Richard Horton of the book How Doctors Think by Jerome Groopman. In the book, Groopman looks at some of the thinking errors and biases that doctors exhibit when they analyse patients and make decisions about what action to take. I found this part of the review very interesting, because as an investor, we carry out similar processes of analysis of charts, companies and the economy, which leads to us making investment decisions. The remarkable thing was how easily we suffer from the same kind of errors and biases in the way we think in carrying out our roles in the markets.

Groopman has drawn his ideas from what Horton describes as the emerging cognitive science of medicine. However, none of it was really new to me. I had encountered every one of the errors and biases in my prior reading and study of behavioural finance.

Attribution Error

This error comes in for the doctor when he or she quickly classifies the patient into an often negative category, like having a mental health problem. This means that the doctor then, under time pressure, uses heuristics that have been found useful for that kind of patient, without taking the time and making the effort to analyse the patient's situation and conditions as a unique case. This is akin to unconsciously thinking that all patients with mental health problems should be treated in some kind of standard way.

Heuristics, or rules of thumb, are very useful in all occupations as a shorthand way of dealing with common situations and problems. Where they fail us is if our initial attribution of the classification to a situation is incorrect. Then, it will often be the case that everything we do from there on is based on an invalid assumption and the decisions are therefore likely to be wrong, or at least sub-optimal.

Many investors fall into this error. They have heard and read that technology stocks are risky. So, as soon as they come to one, they assume it is also risky and make a snap judgement that they should avoid it. This can result in them missing excellent opportunities.

What they should be doing is distilling from their reading and studying what the key risk indicators are in a technology company. Then they should assess the technology company they have come across on those criteria to see whether it indeed fits the mould. If it does, maybe they should quickly move on. However, if this particular technology company is really different on some or all of the key risk indicators, then it would be desirable to evaluate it on its merits without regard to the usual heuristic, which is inappropriate in this case.

Availability Error

A somewhat similar error is when a doctor has treated someone recently and that case is very strongly in the doctor's consciousness. If the new patient is carefully examined, and is indeed suffering the same problem as the recent patient, then no harm may be done. On the other hand, if the doctor has jumped to a conclusion on the basis of recent and graphically recalled experience and does not fully investigate the new patient's condition, then an incorrect decision might be made, which may delay administration of the correct treatment and even be harmful to the patient.

Many investors fall into this error as well. It is at its most potent when the past event is recent, has happened to us personally and particularly if it has left very vivid visual memories. In my parents' generation, the great depression has left an indelible image of failed shareholders suiciding from skyscrapers during the crash and the dole queues of the years of depression. Many of them have been left with a morbid fear of the stock market and a saving mentality that is rooted in their fear of another depression.

In more recent times, we have had the stock market crash of 1987. This happened in October and many investors of my generation recall it very graphically. Still today, television sometimes uses images of the 1980s era stock exchange trading floor with its frenetic chalkies trying to keep up with soaring and then plunging prices. It has left behind a fear of the month of October in the minds of this generation. Some even call it Octoberphobia. This is availability bias in the raw. October is not statistically a bad month on the stock market. In fact, if you take the 1987 even out of the numbers for the last seventy years, October is a very average month and often leads into a rally to the end of the year. If you are interested in the facts, September is a far more dangerous month, but only in bear markets.

So, those who do not recognise that their Octoberphobia is availability bias at work, will as a result tend to make less than optimal decisions compared to someone who had no similar graphic memory of 1987 and acts instead on the basis of the statistical evidence.

Search Satisfying Error

This is quite a common thinking trap for doctors. They may be confronted with a patient with some possibly ambiguous symptoms. The doctor will then make an examination and order some tests, looking for a cause. Sometimes a possible cause that satisfies the doctor emerges quite quickly and the doctor may pounce on that as the cause and proceed to treat it. This may in part be intellectual laziness, but more likely it is heavily overlaid with pressure of work and time. The cause found may exist alright, but it may be only one of several alternatives and the cause or causes that have not also been rigorously eliminated could be the critical ones. Until they are found and dealt with the patient may not recover.

Some readers will be familiar with the person who freezes in the face of overwhelming choice. These are often perfectionists. For them the heuristic of choosing quickly something that may not be the ultimate best, but which satisfies the need is a good one. However, this is quite different to the search satisfying error of not investigating until an absolutely critical cause of a problem is isolated.

Investors fall into this trap often also. They might invest in a company which they like. Then it does not perform quite as well as they expected. They look for a reason. They might even ask the company. They are told that there is a small problem, but don't worry, it has been fixed. Most companies will say that in one form or another, because their job is often to reassure wavering shareholders. Quite frequently, the investor will accept that without looking further and hang on to the shares.

Sometimes this will be fine, but other times the real reason for the poor performance will emerge later and the investor's loss will be greater. Greater that is than it might have been if the investor had not been satisfied with the first and easy answer given to the investor and had done two things. First, the investor might have delved deeper until satisfied that there were no other problems. Second, the investor might not have relaxed and moved on, but made an effort to monitor the situation closely, looking for specific evidence that the problem was fixed and that the poor performance had ceased. If the poor performance had continued despite the supposed problem being remedied, the investor might have found the real problem and got out before large losses mounted.

I did this once with a company which had an unusually high inventory on its balance date. The company had said in its annual report that this was just a timing problem and would be resolved in the next month. I diarised to phone the company a month later and ask specifically whether the inventory level had been reduced as promised. I was assured it was. Moreover, the share price was now moving up quite well. You might feel that the company could have lied to me after the month was up. True, but that would have been a very dangerous thing to do in the era of continuous disclosure. Even if they had tried to obfuscate, the insiders would not have been bidding the price of the shares up on the market.

Confirmation Bias

This bias is not unlike the previous error. It is very common. Most people do not even realise they are subject to it, doctors included. It occurs when the doctor makes an initial supposition of the cause of the patient's problem. The doctor quickly looks for some confirming evidence and finds it, even though it is not strong and there are other inconvenient loose ends. The doctor has looked only for the confirmation that supported the initial diagnosis. Many doctors will then find it difficult to change their mind. This might be because the doctor never looks for other evidence, having confirmed the original supposition. It can also be the issue of pressure of work and time that the doctor falls for a bias which should be well-known.

Technical analysts are prime prospects for this bias. I have lost count of how many times I have been shown a situation on a chart. The analyst then shows me a past situation on the chart of that or another company, which resulted in a very profitable trend. The analyst infers that the result will be the same, based on the way the chart unfolded from that set-up before.

This is confirmation bias written in large letters. If we want to examine a set up to see how well it works there is no short-cut like this. What we should do is try to find as many similar set ups in the past as we can on all sorts of charts in different market situations. Computers can be very useful in finding hundreds of past examples providing the set up can be rigorously defined (not always easy). Then we should record how many times the result was an upward trend and how many times the result was different. We might find that the set up does not work out well all the time and maybe not even half the time. This will defeat confirmation bias, which was finding a few examples like the present one, rather than searching for how often the set up does not work out as desired. Of course, there is still more analysis that might be done on all the examples, but that is beyond the scope of this discussion.

Conclusion

These errors and biases, to which we are all subject, are not easy to overcome. They afflict us most when we are short of time and energy and do not approach our investing problems with the intellectual rigour needed to make good decisions.

The first step in avoiding, or at least minimising, them is to become aware of these errors and biases. Top investors will strive for better results through awareness of them and knowing that the best investment decisions are made after running a mental checklist of them before making any final investing decision. Even after that, try to retain awareness that there is always some doubt about any situation. Try to remain open-minded about the possibility that further evidence which comes to hand may require re-examination of the original decision.

You will know when you are on top of these biases and errors when you begin to see other investors around you falling into the mental traps set for them by these biases and errors in thinking.

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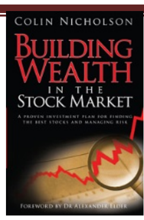

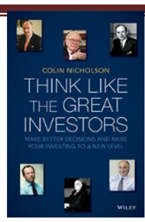

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