Hindsight and Investing

Who among us has never struggled to solve one of life's little puzzles? Like working out how to fix something, when the method was not clear and the parts that we needed were apparently not available. After many false starts and experiments we found a solution. Feeling pleased with ourselves, we describe the problem and our thinking process to a friend, who says nothing until we finish our long and detailed explanation. When we announce our solution, our friend says: "but that is obvious – I knew that". It is entirely possible that the friend did indeed really know the answer to our problem before we started talking, but most likely the friend has just exhibited the hindsight bias.

The hindsight bias is when we think something was easier that it really was, because we are using information that we actually found out afterwards. So, if we had described the problem to our friend and asked them what the solution was, it is likely they would have been as puzzled as we were at that stage. However, once we tell them everything we found out, they imagine they knew some of those things beforehand and therefore it was not such a tough puzzle after all.

Investing involves making judgements, the result of which we will not know until later. This makes investing fertile ground for the hindsight bias. When an investment works out well, we all tend to think that we were smarter than we were. Even more insidiously, when an investment works out badly, we tend to put it out of our mind. It is a healthy strategy to learn lessons from things that do not work out as we planned and move on. However, if we do not ponder the reasons why an investment may have failed and draw lessons from it, we may open ourselves up to a real trap:

- On the one hand, we recall vividly the investments that panned out as we hoped and take credit for what may really have just been good fortune.
- On the other hand, we simply forget about the investments that did not work out well, learning no lessons.

The result is that we have a totally biased memory of our investing prowess. In short, we may tend to think that we are smarter than we are. This can easily set us up for further failures.

The hindsight bias arises out of two tendencies that all of us have. The first is selective memory. We remember what is pleasant (profits) and we suppress memory of things that cause us pain to recall (losses). When we describe our investment exploits to others we focus on those investments that worked out well and which cast us and our investing ability in good light.

We have all been listeners to what are called “war stories” by our friends. We have most probably also told our own war stories to others. War stories are those exciting accounts we reconstruct verbally from our memory where an investment worked out brilliantly. Everyone loves telling war stories because they present us in a very favourable light as brilliant investors with superior skills. What we need to be very aware of is that they are great entertainment, make friends feel good about themselves and about us when we compliment them on their investing exploits, but are rather unhelpful as a way of learning to be a better investor.

Of course, we are most unlikely to mention our poor investment judgements. If we mention them at all, it is to bemoan how bad luck struck us, implying that it was really not our fault. Not taking responsibility for poor judgements and learning from them is one of the best known ways to avoid improving our investment skills. Remember, this is something that we all do to ourselves.

Because of our selective memory, we all tend to overestimate our number of wins relative to losses. Next time we find ourselves telling a war story, try to remember an investment that did not work out, relate that and explain what we learned from the experience. If we do this we have a chance of becoming a much better investor over time.

Likewise, when someone tells us a war story, we should try to politely ask what they learned from their experience. It may not be a good policy to ask them to talk about one of their poor investments and what they learned from it even when we have first been open with them about one of our failures.

The second tendency that causes hindsight bias is our inability to reconstruct exactly what we knew at the time we made an investment as apart from what we found out afterwards. We tend to assume that we knew some things that in fact we could not have known at the time that we made the decision.

There is an excellent way to drive this point home to ourselves, especially if we start out thinking that it does not apply to us, only to others. This is to keep an investment journal. At the time we make an investing decision (it must be AT THE TIME. Later is not effective), we should write down everything we knew and took into account together with what decision we made. Then after the investment has been sold, whether it was at a profit or a loss, write down what we think happened, without first checking the journal. Then read what we wrote at the time. With both winning and losing investments, my experience is that we will find ourselves thinking now that we knew things that we did not record as knowing at the time of the decision and most likely heard about later. This is one of the single most powerful ways to improve our investment skills that I know.

Hindsight bias leads to two important problems in investing:

The first problem

This is that hindsight bias reduces our ability to learn from the past. In order to learn and improve, we have to know two important pieces of information:

How many of our investments were profitable and how many of our investments made losses. Further, what the relative sizes of the profits and losses were. This means we must keep good records and summarise them in a way that presents useful opportunities to have a balanced view of our own performance as an investor.

It also means that our record keeping must be constructed as described for the journal earlier. This is so that we can check back on what we thought when we made each decision and examine what came to light subsequently, which we might have taken into account or, if it could not have been known in advance, what we might have made general provision for because there is uncertainty in every investment. If the hindsight bias causes us to think we knew things we could not have known, we will think we were smarter than we were and not take away the lessons for future application.

The second problem

This is that hindsight bias promotes overconfidence. If we think we made better decisions that we actually did, it may lead us to take greater risks than we should in the future. Even more dangerous to our investment account, we are most likely to overestimate the probability of future success and underestimate the probability of future losses.

Of all the biases and errors investors fall into, hindsight bias is one of the more difficult to deal with. However, just knowing about a bias can take us a long way to avoiding it, so by reading this article, you have taken the first step to maybe avoiding it in future.

Nevertheless, that is not enough. We must work at it consciously. The steps are:

- Keep good records
- Summarise them into useful tables that quantify the number and size of profits and losses
- Make a conscious effort to think through the ways an investment situation might have worked out differently.
- Think about how we might do better in future and write down strategies to improve our investing methods.

This is very powerful, but of greater potency is keeping an investment journal at the time a decision is made. We should record what we knew then and what our thinking was. Then, when we evaluate our decision, we must resist the urge to think that we knew anything that is not in our journal diary. It works, because it enables us to recreate what we knew and thought when we made the decision. Then we will be on the way to defeating the hindsight bias. I do this for every stock I buy – and publish my journal progressively on the members website.

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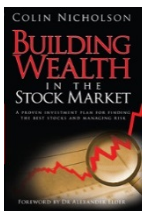

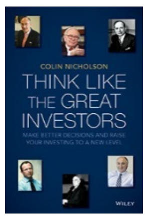

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