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Behavioral Finance

BEWARE THE NATURAL HUMAN ADDICTION TO PREDICTION

By Stan Clark, Senior Wealth Advisor

"What's going to happen with house prices?" "How about oil and the stock market?" "Is a Canadian team ever going to win the Stanley Cup again?"

All of us hear such questions all the time. There's no way anyone can know the answers – but that doesn't stop a lot of people from coming up with predictions.

Human beings are driven to try to predict the future. The drive is so strong that researchers have called it a *prediction addiction*. Brain research has actually identified a region of the brain and a specific chemical – dopamine – that practically forces us to forecast.

Over the course of history, we've used dozens of predicting methods, such as tarot cards, tea leaves and crystal balls. Since the beginning of time people have sought out fortune-tellers, psychics and seers. Unfortunately, most prophets are false prophets.

Truth is, although we're strongly attracted to forecasting, we're just not very good at it. As the eminent philosopher and baseball player Yogi Berra once said: "It's tough to make predictions, especially about the future."

Some bold forecasts from the past bear this out:

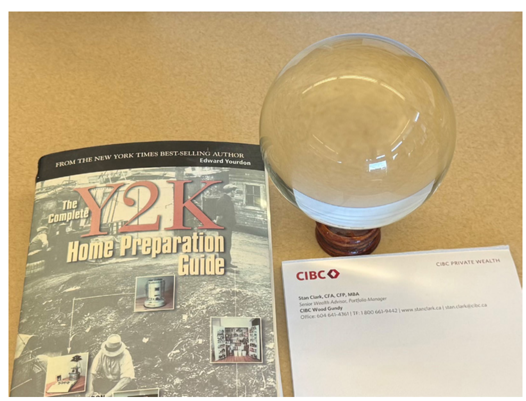
"A severe depression like that of 1920-1921 is outside the range of probability." That's what the Harvard Economic Society wrote on November 16, 1929 – just before the start of the Great Depression. Or, how about: "It will be years, not in my time, before a woman becomes prime minister," said Margaret Thatcher on October 26, 1969. Then there's this more recent gem: "There's no chance that the iPhone is going to get any significant market share" – Steve Ballmer in *USA Today*, April 30, 2007.

Forecasting corporate earnings is just as bad. Earnings are the key bottom-line number that investment analysts try to predict. In a study[1] covering more than 94,000 estimates over 24 years, earnings estimates were off, on average, by an amazing 44%! That's a huge error for something so important. But, even though their ability to forecast is so poor, analysts still fool themselves and others into thinking they're good at it. Perhaps their real skill is getting us to remember their correct forecasts – and to forget their dead-wrong ones.

We're attracted to forecasting because we're wired to do it. And, because our brains fool us into thinking we're better at it than we really are. Behavioral finance has uncovered many biases that keep us trying to divine the future – including *hindsight bias, optimism, filtering and confirmation bias*.

Economic forecasting is especially difficult, for three reasons:

First, there are thousands of factors involved. The human mind just isn't wired to take that many factors into account. Studies show we can hold maybe six or seven in our mind at any one time. The tremendous prediction machines at the heart of modern artificial intelligence (AI) might help with this first challenge, but it seems likely that they will continued to be stymied by the next two challenges, described below.



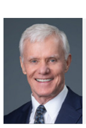
Here's the second. Many of the factors, such as human creativity and the emotional reaction of crowds, are simply unpredictable. You know things are going to change, but it's super hard to figure out the details of what the change will be and how it will occur.

Third, there's an element of circularity involved. People adjust their actions based on the forecasts themselves. An example of this was the Y2K hype in 1999. All those predictions, of planes falling from the sky and computer systems crashing, turned into non-events. This is because people took actions that prevented the predictions from coming true! I keep a copy of the book *The Complete Y2K Home Preparation Guide* right beside my crystal ball to remind me of this.

The problem with predicting is that we bet too heavily on what we think are the likely outcomes. And, we over-pay for things based on highly suspect forecasts. Besides, forecasting takes time, and this diverts us from focusing on things that are truly productive.

Summing up: Looking for economic or stock market prophets is not the best way to make economic and stock market *profits*.

[1] David Dreman, Contrarian Investment Strategies



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