The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

Confirmation bias is normal – but dangerous for investors

By Stan Clark - Senior Investment Advisor

Last month we discussed how *confirmation bias*, an all-too-human tendency, results in our selectively searching for, interpreting and remembering information that confirms our initial views – while overlooking contrary data. Confirmation bias could just as well be called *selective unconsciousness*, because we don't consciously intend to deceive ourselves. The tendency arises, unconsciously, from our human nature.

In this issue, I'd like to discuss how confirmation bias, though natural to us as humans, can be dangerous to us as investors.

Confirmation bias is pervasive. It affects what we believe and how we act – sometimes with unfortunate results, leading us to make serious investment mistakes.

Most of us approach investing subjectively. It's no coincidence that, over the long term, many investors also underperform market averages. Confirmation bias is one reason subjective investing doesn't work well.

Say I'm an analyst. I'm trying to figure out whether ABC Corp is worth investing in. I am initially biased in ABC's favour. Maybe I once worked for them, or a friend recently joined them, or my sister swears by an ABC product. Whatever the reason, my first impressions are positive.

So, when I start researching ABC, confirmation bias goes to work. I think I am being unbiased, but it's hard for me not to favour information supporting my first impressions. When I tour ABC, I notice things that support my bias. Unconsciously I ignore or downplay things that don't. I notice the fancy new machines the company has installed. Yet I overlook the atmosphere of employee discontent.

Not only am I selective in the information I find; I interpret facts to support my case. Let's say the CEO has spent her whole life at ABC. I can easily interpret that as positive: She's loyal; has lots of direct experience in the company; knows ABC inside and out. Now let's say the CEO has worked at several different companies. I can spin that positively, too: She is widely experienced; sought after by other companies; flexible.

Our minds are adept at creating arguments to support what we want to believe. When it's time to make my forecast for ABC Corp, I cannot help but create a favourable one.

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If all analysts and investors were evenly distributed in their first impressions, then we would expect the same number of people to be positive or negative about any given company. But a surprising number of analysts and investors are predisposed to think favourably about companies that have been doing well for the past few years, and to view unfavourably companies that haven't performed as well. Confirmation bias causes them to favour and buy overvalued stocks. And, unfortunately, to sell undervalued stocks – the exact opposite of what leads to good investment returns.

The Internet has made confirmation bias even more prevalent. It's easy to find information or opinions supporting almost any point of view. Add thousands of different TV and radio stations, magazines, newspapers and blogs to the mix, and it's not hard to find a select, steady stream of media that support our biases.

What's the moral of this story? If we approach investing subjectively, we must be aware that confirmation bias exists and will likely have a negative effect on our buying and selling decisions. Counteracting this bias is hard work. That's why it makes sense to use a disciplined, objective approach to investing – to take bias right out of the equation.

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