The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 4 - Issue 11

Behavioral finance

Fooled by randomness

By Stan Clark - Senior Investment Advisor

Imagine you're the coach of a basketball team. There are 10 seconds left in the game – and your team is down by a basket! Your star player, who over the course of his five-year career has made 55 percent of his shots, is only two for 10 on the night. Another veteran player on your team has made 10 of his last 10 shots – even though his five-year shooting percentage is just 45 percent. To whom would you give the ball for the last shot of the game?

We pretty much know that most coaches would give the ball to the player who has just made 10 shots in a row. That player has a "hot hand" – so we think. Well, researchers have studied such scenarios. Their clear conclusion is that, regardless of how many shots a player has made or missed in a row, the odds that he will make or miss his next shot are the same as you would expect from his overall, career-long shooting percentage.

When this research was first made public, the sports world greeted it with strong opposition. People just seem unwilling to believe the hot hand is a myth! We intuitively feel that a long streak *must* mean something else is at work.

Over the past couple of years, I've given talks on behavioral finance to a variety of groups. As part of my talks, I usually conduct an experiment. First, I ask people to imagine flipping a coin 50 times, and write their results on a piece of paper. We then look at the longest string of heads or tails from their imagined coin flips. Every single time I do this, participants dramatically underestimate how often strings of five, six or seven in a row would occur with random flips.

We then conduct an *actual* demonstration of 50 flips. And, invariably, one or more of these long strings occur – to the surprise of everyone.

The lesson we draw from the experiment is this: We dramatically underestimate how often longer strings occur in situations that we know are purely random.

In his 2012 book *The Success Equation*, Michael Mauboussin examines the relative contribution of skill and luck – or randomness – in business, sports and investing. Mauboussin finds there is far more randomness in all these areas than most people think. Randomness plays a much bigger role than most investors believe, certainly over the very short term – but also over longer periods.

In an earlier book called *Fooled by Randomness*, Nassim Taleb discusses in detail the hidden role of chance in our lives. I highly recommend both books.

What all this can mean with investing is simply this. If we see a stock, mutual fund or money manager having three, four or five years in a row of really good performance, our natural inclination is to think it's been caused by skill – and therefore likely to be repeated. In reality, there's a good chance it was in large part luck, like the toss of a coin. When you buy stocks, it's important not to put too much money into any single company. Diversification is key. And, when looking at a money manager or investment strategy, you have to look at far longer track records to make any meaningful conclusions. Be careful not to get fooled by randomness.

Stan Clark is First Vice-President, Portfolio Manager and Senior Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

To learn more about CIBC Wood Gundy, The Stan Clark Financial Team and the many ways we can help manage your wealth, please contact us by phone or by email as listed below.

CIBC Wood Gundy | The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca

Stan Clark is an Investment Advisor with CIBC Wood Gundy in Vancouver, BC. The views of Stan Clark do not necessarily reflect those of CIBC World Markets Inc. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. Clients are advised to seek advice regarding their particular circumstances from their personal tax and legal advisors.
If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada.