The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

Lake Wobegon, where all investors are above average

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In 1965, two Seattle-area psychiatrists asked 50 drivers to rate their skill, ability and alertness the last time they had driven. Nearly two-thirds said they were at least average. Many described their most recent drive as "extra good," or even "100 percent." Remarkably, they were being interviewed in a hospital – where each of them had ended up after an accident while driving.

According to the police: 34 of those drivers were directly responsible for their crashes; 29 had at least two past traffic violations; 28 had totalled their vehicles. Twenty-two even faced criminal charges! Many had ghastly injuries. Yet they insisted they were good drivers. Were they crazy?

Not at all. It's a basic characteristic of human nature to think we are better than we really are. Another survey, of drivers with clean records, found that 93 percent believed themselves to be above-average drivers.

The tendency to think we are better than we are has been called the *Lake Wobegon effect*, after the fictional town "where all the men are strong, all the women are good-looking and all the children are above average."

Behavioural scientists have found that this phenomenon – the *self-enhancement bias* – exists in almost every area of our lives. If you ask 100 people, "Compared with the other 99 here, who's above average at X?" – roughly 75 will raise their hands, whether X is driving a car, playing basketball, telling jokes or scoring well on intelligence tests. This, despite the fact that, by definition, half the people must be below average.

This bias certainly exists in the financial world. Consider this advertisement:

Warning against speculative financial bubbles, the ad mocks some gullible Frenchmen lured into a silly, 18th-century investment scheme. The ad says modern shareholders, armed with superior information, can avoid the pitfalls of the past. "How different the position of the investor today!" the ad enthuses.

The ad ran in *The Saturday Evening Post* on September 14, 1929. One month later, the stock market crashed, the start of the biggest three-year decline ever.

"Everyone wants to think they're smarter than the poor souls in developing countries, and smarter than their predecessors," says Carmen Reinhart, University of Maryland economist, and co-author of *This Time It's Different*. In their book, Reinhart and Kenneth Rogoff looked at booms and busts over the past 800 years. As their title suggests, although every crisis seems different from the others, all are very similar. People do not learn well from history. They believe they are smarter than those who came before them – but they're wrong.

Having confidence is normally a healthy trait. However, when combined with other traits, such as filtering, hindsight bias and confirmation bias, it leads to overconfidence – and, an unrealistic assessment of our abilities to analyze and predict.

Overconfidence can get you into trouble with your finances. It can cause you to take risks you shouldn't, and to ignore information that disagrees with pre-existing biases. It's tough to combat, because most overconfident people are also convinced they are not overconfident!

The more overconfident someone is in their beliefs about the future, the more likely they are ignoring important information, or rationalizing facts to fit their beliefs. Beware the overconfident expert. Sure, people are more likely to follow a very confident person. But keep in mind that the most dangerous predictions come from those who appear most confident about them.

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.

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