The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

More information increases confidence – but what about accuracy?

By Stan Clark - Senior Investment Advisor

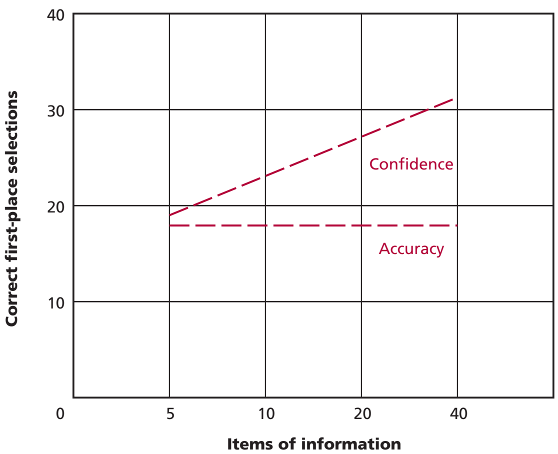
In the late 1980s, Massachusetts Institute of Technology (MIT) psychologist Paul Andreassen conducted an experiment. First, Andreassen asked each of his business students to select a portfolio of stocks. Then, he split the students into two groups. The first group only saw changes in the prices of their stocks. The second group received a steady stream of financial information through TV, newspapers, company contacts and industry analysts.

Surprisingly, the first group, with less information, ended up earning more than twice as much as the well-informed group. For the second group, being exposed to extra news was distracting. These high-information students became focused on the latest rumours and gossip. They believed all that extra information would allow them to anticipate the market – but they were wrong.

Previously, I have discussed our addiction to prediction – how we have a strong, natural craving to make predictions. We do this, even though we aren't very good at predicting such complex things as the economy, company earnings or the stock market. I've also discussed overconfidence: How most people think they are better at things than they really are, and how overconfidence can lead to trouble.

As the MIT study showed, more information tends to increase our confidence. But it does little to improve forecasting accuracy – and may actually reduce it.

In another example, eight veteran horse-racing handicappers were progressively given five to 40 pieces of information they considered important for picking winners. As the graph shows, their confidence rose as the information increased – but their number of winners did not.



Source: Adapted from Paul Slovic, "Behavioural Problems Adhering to a Decision Policy" IGRF speech, May 1973

In still another example, clinical psychologists received background information on a large number of cases. The psychologists were asked how likely it was they could make a correct diagnosis with the information provided.

As the amount of information increased, the psychologists' confidence rose dramatically. But their accuracy did not. With very little information, they thought they'd get 33 percent right. Actually, they *did* get 26 percent right. When the information was increased fourfold, they expected to correctly diagnose 53 percent of cases. But they were right only 28 percent of the time! More information made them much more confident, but no more accurate.

Here's another instance. A group of university counsellors received transcripts, test scores, vocational tests, application essays and other information about high school students. They became highly confident they could accurately predict the grades those students would get at university. But a basic mathematical formula that had only two variables – the students' average high school marks, and their scores on a single, standardized test – made far more accurate predictions than the counsellors did.

Study after study has shown that simple statistical models are often better at making accurate predictions than well-informed experts – all of whom are subject to behavioural bias.

To avoid behavioural biases, the Stan Clark Financial Team uses disciplined stock strategies based on objective factors proven to produce good returns over long periods. We also consciously guard against being influenced by extraneous, but seemingly important, information. This, we believe, will help us produce better-than-average returns – and better returns than the majority of investors who use more subjective approaches.

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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