

PERSPECTIVES

An excerpt from "Perspectives" - Volume 7 - Issue 5

Behavioral finance

Trust your intuition? Sometimes – but not for picking stocks

By Stan Clark - Senior Investment Advisor

An art expert glances at a museum's proud new purchase. She declares, "It's a fake."

A veteran fire captain fighting a small fire in a kitchen yells to his men, "Let's get out of here!" Seconds later, the floor collapses into a much bigger fire in the basement.

At an auto show, the manager of a mutual fund sees the latest vehicles from a big-three auto company. Impressed, he buys millions of shares in the company.

All three of the above scenarios are examples of what we might call "intuition at work." The first is from Malcolm Gladwell's *Blink: The Power of Thinking*. The second is from Daniel Kahneman's *Thinking, Fast & Slow*. Both show intuition at its best and most valuable. But the third scenario is one that no smart investor, familiar with behavioral finance, should ever trust. Let's study the differences.

First, let's examine what we mean by *intuition*. Renowned psychologist Herbert A. Simon, a Nobel Prize winner in economics for his work on decision-making in organizations, says of intuition: "The situation has provided a cue; this cue has given the expert access to information stored in memory, and the information provides the answer. Intuition is nothing more and nothing less than recognition."

In the examples of the fake statue and the fire, we are dealing with something you might call *expert intuition*, which can only come from years of experience and study. In the example of the stock pick, we are looking more at a gut feeling, a decision made mostly for emotional reasons and therefore not a reliable one.

To be sure, it may turn out through sheer luck that the stock pick was a good one. But in the long run, the fund manager who relies on personal judgments is going to make as many, if not more, bad decisions as good ones.

As we have been saying in many of our previous articles on behavioral finance, formulas- and rules-based decision systems are better than subjectivity and intuition in making many types of decisions.

Kahneman refers to studies in a variety of disciplines. He notes that, in 60 percent of studied cases, decision-making based on simple rules was a lot better than personal judgments. In no case was the rules-based approach worse.

Kahneman and other researchers have found that simple algorithms based on a limited set of parameters, five or six at most, outperform expert opinions and predictions. This is true from investing to such diverse fields as predicting wine prices, interpreting X-rays, choosing good political leaders, and forecasting who will do well at college. The

more subject something is to irregularity and random fluctuations, the less accurate will be the subjective judgments of experts.

An investor, whether professional or not, operates where there are hundreds, possibly thousands, of variables. These can range from who is on a company's board of directors to the political situation in Chile. The variables all can and do affect stock performance. Very often an investor's success can be put down to pure luck – but just as often, that luck may be wrongly ascribed to skill.

That is why you shouldn't trust the subjective stock picks of experts, no matter how confident they are about them. As Kahneman says, "The confidence that people have in their intuitions is not a reliable guide to their validity."

Stock-picking is an area where, in the long run, systematic, rules-based systems will outperform intuitive ones. ■



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.



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.