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Behavioral finance

The Siren song of stories

By Stan Clark - Senior Investment Advisor

One of the most seductive dangers investors face is called *the Siren song of stories*. Remember the Sirens from your school days? In Homer's *Odyssey*, they were island creatures who lured nearby sailors with their irresistible songs, causing the sailors to crash their ships on the rocky coast. No man could hear Siren songs without perishing.

For humans, it seems *stories* are equally irresistible. If we're not careful, stories can lure us into making big investing mistakes.

Consider this interesting psychological example cited in James Montier's excellent *The Little Book of Behavioral Investing*. In a study, organizers gave participants statistical information on the effectiveness of a treatment for a fictitious serious disease. Organizers also gave participants a story: positive, negative or ambiguous. They then asked if participants would want to undergo the treatment. The result? When participants heard a positive or negative story, they almost totally ignored statistical information in favour of the story. For example, when participants heard the treatment was 90% effective, but they also heard a negative story about it, only 39% opted for the treatment. However, when they understood the treatment was only 30% effective, but it came with a good story, 78% opted for the treatment.

Why do we find stories so compelling? Well, when you think about our past, it makes perfect sense. For most of our evolution, we were storytellers. Before we had writing, we passed knowledge on through stories. If our ancestors didn't heed the lessons in the stories, they often didn't survive. This trait of paying attention to stories is deeply embedded in our psyches.

Statistics, on the other hand, just don't connect with us the same way. "Sorry," our emotions say, "I can't relate to those numbers. Give me a story instead."

What does this have to do with investing? One of the puzzles of investing is: *Why do most people underperform market averages over the long term when there is ample evidence of simple ways to outperform them?* For example, as Michael Chu notes in his article this issue, "The value of value," companies with low ratios of prices compared to intrinsic value (for example, low price-to-earnings or P/E ratio) tend to do better than companies with high ratios. If that's the case, and the evidence is overwhelming, why would anyone buy companies selling at high price ratios?

It turns out that most companies with high price ratios have very attractive stories behind them. The stories often include forecasts of wonderful things to come in the future, compared to how things are now. Even if investors know that forecasts are unreliable – and even if they know that stocks with high ratios tend to do poorly – they still go ahead and buy those stocks. That's because the stories have influenced them in ways the statistics can't. And if initial stories come true to some extent, the stories cascade and multiply, providing the rationale for buying more at even higher prices. This can work for a while – until it doesn't.

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We're all human, and it's just so darned hard to resist a good story, especially when it sounds so convincing!

What should we do about this, and how do we avoid getting lured into these investing rocks? As with many behavioral finance problems, just being aware of a bias helps – but it's often not enough. Our human brain is exquisitely skilled at fooling ourselves into thinking we're acting rationally, even when we're not. It might also help to resist seeking out the stories, which is hard to do with the Internet and media constantly bombarding us. Try to either tune out the tempting stories, or at least listen to them with skepticism. Be wary when someone tries to influence you with a good story. And when you do hear a good story, focus on the facts, and invest where the numbers make sense – not where the story sounds good. ■

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.

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

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