The Stan Clark Financial Team's

# PERSPECTIVES

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Behavioral finance

## How hindsight can hurt our foresight

*By Stan Clark - Senior Investment Advisor*

**At the start of every year we see reviews of the past 12 months, trying to explain what's happened and forecast what lies ahead. We just can't seem to get enough of these reviews and predictions! It's like we have an addiction to predictions. Our rational minds know most things cannot be forecast, yet our emotional minds crave divining the future.**

In this issue, I'd like to discuss a common bias known as *hindsight bias* – and explain how hindsight can hurt our foresight.

Hindsight bias was most famously demonstrated in a study published by Baruch Fischhoff and Ruth Beyth in 1975 titled, *I knew it would happen*.[1] The Fischhoff and Beyth study focused on President Richard Nixon's 1972 trip to China, the first trip there by an American president since Mainland China became communist in 1949. There was intense speculation about what the outcome of the trip would be. Few expected what actually happened: that both countries would pledge to work towards normalizing relations.

Before the trip, Fischhoff and Beyth asked dozens of students to predict the probabilities of various outcomes. Then, at two intervals after the trip, they asked the students to recall their earlier predictions. Fischhoff and Beyth found that when an event occurred, most students believed they had assigned a higher probability to it beforehand than they actually had. But if an event did *not* occur, the opposite was true.

This is hindsight bias: the tendency to believe our forecasts were more accurate than they really were. It is also the belief that once events have occurred, these were more predictable than they really were. In retrospect, things do often appear to have been much more predictable than at the time of forecast.

Dozens of studies have documented hindsight bias. And indeed we've seen many examples of it over the past several years: the inevitability of the global financial crisis in 2008; the "sure thing" of growing dominance by large tech stocks; the rebound in company profits and prices after the pandemic panic in spring 2020; and the longer-term decline in interest rates. With the benefit of hindsight all these seem to have been inevitable.

Hindsight bias makes us believe we're better forecasters than we really are, and that the world's a more predictable place than it really is. Perhaps this bias is a way of making life seem more reassuring, as Nobel Laureate Daniel Kahneman suggests:

*There are many causes of hindsight bias. Most are rooted deeply in our emotional mind, which makes the bias hard to avoid.*

"Hindsight bias makes surprises vanish. People distort and misremember what they formerly believed. Our sense of how uncertain the world really is never fully develops, because after something happens, we greatly increase our judgements of how likely it was to happen."

There are many causes of hindsight bias. Most are rooted deeply in our emotional mind, which makes the bias hard to avoid. How does this hurt us? Well, one of the biggest problems is that we give too much credibility to forecasters who have been right in their recent predictions. Their correct predictions may very well have been pure luck. But, because of hindsight bias, we are much more likely to attribute their success to skill.

What can we do to fix this? As with many behavioural biases, the most important thing to know is that you can't. You just have to learn to live with it. Keeping a journal of your past predictions, or of others' predictions, can help. Stay aware of this tendency, and keep asking yourself, "Was this really as obvious as it now seems?" Remember, the world is complex, and most things are not as simple as they seem – even in hindsight. ■

[1] *Organizational Behavior and Human Performance, vol. 13, pp. 1-16.*

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