The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

How the news can hurt your investment decisions

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You see a graphic TV news report about an earthquake. At once you think: *It could happen here, too*. You are on edge for days, even weeks.

You read an item about a mass shooting. You fear for your safety on the streets. You hear about a child being abducted. You worry that your own child is next.

You read about an executive going to jail for insider trading, or about corporate greed. You start believing all publicly traded companies are bad.

In this issue, I'd like to show how the news can hurt your investment decisions.

The fact is, once people hear dramatically bad news, they tend to overestimate the probability of it recurring. This is a psychological phenomenon called the availability bias.

Take shark attacks. These hardly ever happen. But when they do, many people become so frightened they stay out of the water for a while, if not indefinitely. The fact is, *it's in everyone's nature to estimate what is likely to happen based on what is most current in their memory*. This is especially the case with vivid, unusual or emotionally charged events.

In truth, of course, you are likely to survive even a massive earthquake. Our streets are no more dangerous today than yesterday. As for child abduction? Extremely rare. But the news by its very nature focuses on the exceptions or the dramatic. And because this is what the news mostly reports on, we regard these exceptions as the norms. As a result, we feel less safe on the streets, etc., and indeed more at risk everywhere, than we really are.

The same is true about public companies. Most of those who work in public companies play by the rules. Unfortunately, the availability bias can lead people to react too strongly to negative reports about unethical behaviour in the corporate world. For that reason, they may shy away from owning stocks. And that's a shame, because stocks generally produce high returns to shareholders. In the U.S., stocks have averaged 11.1% a year compounded over the past 100 years. No other major asset class comes close to this: not gold, not bonds, not real estate.

This is not to say there aren't problems. Let's face it, greed and dishonesty have always been part of society, in every line of work. Even noble professions such as academia, the church and medicine include some people who lie, cheat, steal or defraud.

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But dishonesty and wrongdoing cannot be that big a factor in the corporate world. Otherwise, the average returns to shareholders would not be as high as they are! Most people working for these companies are simply trying to produce real profits and help their companies grow. Their incentives and interests are usually very closely aligned with those of their shareholders.

The way to deal with availability bias, so that it doesn't negatively affect your investments, is to consciously try to keep a balanced perspective on events. Remember: Investing works best when you diversify and take a long-term approach.

So, don't get caught up in the latest bad news or scandals. Don't let them overly affect your investing decisions. Recognize that recent, emotionally charged events are just that: recent events. They are seldom indicators of recurring probabilities. It's natural to fear they are – but that fear has little basis in reality, and allowing it to overly affect your decisions can seriously harm your wealth. ■

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