The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

Mere-Exposure Effect: How familiarity affects your financial decisions

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You're faced with a choice. One, you can buy shares in a company where you know the brand very well and the numbers look okay. Or two, you can buy shares in a company you don't know well, but where the numbers look quite good. Which one would you be more likely to invest in?

Readers of my behavioral finance articles will probably guess correctly that many people would choose to buy shares in the brand-name company. The reason: They're familiar with the company, even if its numbers aren't as good.

In this issue, we'll look at how familiarity affects your financial decisions.

It's quite natural that we develop a preference for things we are familiar with. This preference is a psychological bias known as the *familiarity principle*, or the *mere-exposure effect*. Psychologists have been aware of this bias, and studying it through tests, since the late 19th century. The mere-exposure effect explains a lot about our personal choices in many areas – including where and how we invest our money.

The bias explains why your next car will most likely be the same make as your current one. It also explains why people tend to fall in love or become friends with people they see repeatedly. In advertising, the mere-exposure effect is the reason why so much advertising money is spent to build awareness and familiarity with brands. That's why, when you buy cornflakes, you'll most likely buy Kellogg's.

The mere-exposure effect is likely rooted in an ancient part of our brain – the amygdala – where basic emotions such as fear and contentment arise. Seeing or doing something that is even just fleetingly familiar makes us feel good.

Investing in domestic companies makes us feel safer and more at ease than investing overseas. This explains why Americans invest mostly in U.S. stocks, Europeans invest mostly in Europe and Canadians invest mostly in Canada. Yet in a globally linked economy, there is no rational reason for people in different countries to have such wildly different mixes.

When it comes to investing in individual stocks, it's good to know why the effect is called "mere-exposure." You don't need to have good reasons to like a company; merely being familiar with something is enough to bias you in its favour. The reasons can come later. This may sound like I've got things backward. But experiments have shown that we often first come to like something unconsciously. Then we consciously build up the reasons for *why* we like it.

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Thanks to the mere-exposure effect, we tend to invest in stocks that are familiar to us in some way. More often than not, investing based heavily on familiarity can hurt your investment returns.

In his 2008 book *Your Money and Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich*, Jason Zweig points out that popular, or "celebrity," stocks usually end up overexposed, overpriced and somewhat risky. They tend to underperform the market by 2% to 5% annually. Nevertheless, many people continue to buy such stocks and ignore better-valued ones that are not as familiar.

Therein lies the danger. The mere-exposure effect can keep you from being objective in allocating your investments and in selecting stocks. That's why it helps to invest according to a set of rules based on reliable, objective information. And equally important, it's why you need to be disciplined about sticking to those rules. ■

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