

PERSPECTIVES

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Behavioral finance

CAUTION: Biases won't disappear just because we know about them

By Stan Clark - Senior Investment Advisor

In past issues, we've discussed biases that affect our thinking and financial decisions. Biases can fool us on everything from hindsight to predictions, and to putting too much confidence in recent events.

We all like to think we are rational. But most of our biases are caused by the limitations of our rational mind. Our subconscious mind has an amazing influence over our conscious mind and our actions.

At the end of my articles on financial behaviour, I usually devote some space to a *prescription*. I suggest how to avoid falling into the financial traps caused by biases. But maybe, with biases, the biggest trap is thinking that just because we know about them, they will go away. They won't!

Let's turn our attention for a moment to science, specifically the *big trap* concept. Have a look at his drawing of two tables:

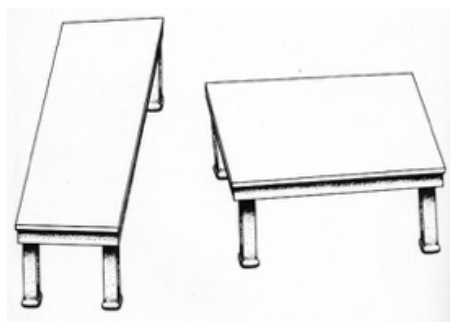


Table A

Table B

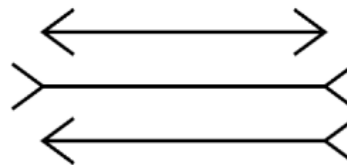
Table A, on the left, looks much longer and narrower than Table B, on the right. You can try turning the page sideways or upside down. But no matter how you view it, Table A looks long and narrow, with B shorter and wider by comparison.

Now try tracing the top of table A onto a piece of paper and then overlay this onto Table B. Are you surprised? Tables A and B are exactly the same size and shape!

There's something yet more amazing. Even once you know the tables are the same size, even if you've cut them out so your eyes can see this for themselves – when you turn back and look at the original pictures, *they still look very different*. No matter how many times I do this, and believe me I've tried it many times, it's still hard for me to mentally grasp that the two tables are the same size.

Merely knowing they are the same doesn't change our perception – our *feeling* – about them.

Now here's another example. Called the Müller-Lyer Illusion, it and consists of a set of arrow-like figures. Which of the three shafts looks the longest and which the shortest?



Doesn't the one at the top, with the two arrowheads, look the shortest? And doesn't the one in the middle, with the two tails, look the longest? Now place a straight-edge ruler along the ends of all three shafts. You will discover the shafts are all the same length. Once again, even when you *know* they are the same length, they still look to be different lengths. So much for the saying "Seeing is believing"!

These two examples show that our visual perception often leaves much to be desired. Our perception can be strongly affected by subtle differences. And it's very important to realize that knowing about perception errors doesn't get rid of them.

In financial decisions, we are similarly faced with a host of biases or illusions. For example, *confirmation bias* causes us to filter and interpret information in a way that distorts the truth. *Hindsight bias* causes us to believe things are much more predictable than they really are. And *anchoring* shows that the silliest things can influence our decisions, like the last two digits of a Social Insurance Number influencing how much we are willing to bid for different products. Seriously!

Knowing about these biases can help. But merely knowing about them doesn't make them disappear. We have to constantly guard against being influenced by them. It sometimes helps to use certain tools, or tricks, to help us make the right financial decisions. I'll write about these next month. ■



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