PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

An Excerpt from Volume 13 | Issue 2 March 2023

Behavioral Finance

THE CLUSTER ILLUSION – SEEING TRENDS WHERE THERE ARE NONE

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Humans try to create order from chaos. We take raw nature and spawn civilizations. We take myriad, sometimes baffling, observations from the natural world and turn them into orderly scientific laws and theories.

As I've mentioned before in my behavioral finance articles, humans are also subject to a collection of cognitive biases. These biases help us make sense of the world. But the same biases can drastically affect our success in certain areas, such as finance and investing.

In this issue, I'd like to discuss one such cognitive bias that is ingrained in human psychology: *the cluster illusion*.

The cluster illusion is a tendency to see meaningful patterns in a random jumble of information. For example, if you were to flip a coin and have 10 heads turn up in a row, you might think the coin is biased. Most likely it is not. In fact, if you were to flip that coin 1,000 times, the odds of getting 10 or more heads in a row at some point are a surprising 62%.

Seeing patterns where none really exist can be problematic for investors. The reason: You could interpret a cluster of strong returns as a trend when, in truth, the cluster is just part of the normal variation of returns.

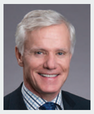
The cluster illusion creates traps for investors. Short-term performance data, whether from a few months or a few years, may persuade us to emphasize a particular class of investments, such as stocks, bonds or real estate. The data may influence our investing style, for example, small-cap versus large-cap, or *growth investing*, versus *value investing*. Such data can even persuade us that a particular money manager is an infallible genius, when that manager's results may just come down to pure luck.

A winning streak may indicate our selection strategy is sound – but the streak may also be no more than a statistical anomaly. In fact, streaks of extra good or extra poor performance lasting three to five years are not unusual in the stock market. But we get fooled by the cluster illusion because the illusion jives so well with our intuition – and intuition, as we know, can mislead us.

It is true that many things experience short, intense cycles. But it's also true that, over longer periods, they tend to regress to the mean. A stock may have a long-term record of good returns, but go through a period of lower returns. That doesn't mean the stock will give a poor return going forward. In fact, the case would likely be just the opposite: It's an even better time to invest in the stock after the lower-return period. In business and economics, to see the real trends you often have to look at 10-, 20- or 50-year periods.

What else can you do to overcome the cluster illusion? Here are a few suggestions:

- Don't place too much emphasis on short-term performance, whether positive or negative. Remember, hot and cold streaks lasting three to five years are common.
- Don't rely on your intuition to guide you when choosing stocks. Instead, use fact-based rules and disciplined strategies to overcome cognitive biases like the cluster illusion.
- Don't attempt to time the market. If you do, your intuition will lead you to want to buy more stocks after they've done well for a few years, and to sell stocks after they've done poorly for a similar period. The right thing to do is usually just the opposite.
- And finally, try not to look at the prices of your stocks too often. The more often you look at them, the more likely you will perceive trends that don't really exist.



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