THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

An Excerpt from Volume 14 | Issue 6 **September 2023**

Behavioral Finance

BEWARE OF COGNITIVE DISSONANCE: IT UNDERMINES FACTS, LEADS TO POOR INVESTING DECISIONS

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When we humans reach an opinion we often stick to it, no matter what. Psychological research shows that even a host of countervailing facts may not be able to budge us one inch from that opinion.

Let's look at a major cause of this common phenomenon, known as *cognitive dissonance* – and how it can undermine facts and lead to poor investing decisions.

Cognitive dissonance is the mental discomfort we feel when new information conflicts with our previously held ideas or beliefs. By making us reluctant to accept the new information, cognitive dissonance is a significant source of confirmation bias. It is also our tendency to seek, interpret or remember only information that confirms our preconceptions.

It leads us – and please bear with me here – to engage in what's known as *dissonance reduction*. That is, we try to resolve our discomfort by tending to notice and accept only information comforting to us. We ignore or modify information that conflicts with existing beliefs. And, we tend to consider or remember only the information that confirms our existing beliefs.

Most people try to sidestep situations that give rise to cognitive dissonance. To avoid psychological conflict, some will even ignore potentially relevant information. Instead, to maintain psychological stability, they rationalize holding fast to their beliefs and understandings.

Consider smokers. They almost certainly know that smoking is unhealthy. But, used to the relaxation of lighting up, they tend to ignore the evidence or minimize the likelihood that smoking could seriously affect them.

So, what has all this to do with investing?

Often investors similarly go to great lengths to rationalize their previous decisions. This happens especially when they've based those decisions on highly subjective factors. To protect their rationalized decisions, these investors may go so far as to avoid selling when the investment proves to be a mistake. This allows a losing investment to get even worse.

Cognitive dissonance may also prevent them from selling something they've made a profit on, even when it becomes overpriced, as in a stock bubble. Such bias may well be what kept many people from selling their tech stocks in early 2000; or from selling their Las Vegas real estate in 2007, before prices collapsed.

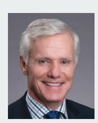
Investors may also turn down the chance to buy stocks they've been negative about – even when conditions change or prices fall low enough to make the stocks worthwhile. For instance, very few people saw the financial crisis building to the extent it did in 2008. And, of those who happened to sell before the stocks fell, very few would have been able to change their minds quickly enough to buy back in when those same stocks hit their lows in early 2009.

What can you do to avoid the errors caused by cognitive dissonance?

When you are uncomfortable about something, stop. See if you can find the inner conflict that's making you feel that way. Always be on the lookout for behaviours and decisions whose main purpose is to reduce the mental discomfort you may have about new information – and about opinions that conflict with your views.

Above all, don't become married to your beliefs. Don't grow overconfident about their accuracy. Recognize that you are human and that almost any belief or opinion you hold could be contrary to the facts. As Mark Twain said, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

Try to adopt the view that being able to admit you're wrong and change your mind is a sign of wisdom and maturity. Your portfolio will thank you.



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