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Behavioral Finance

WHAT BEHAVIORAL FINANCE TELLS US ABOUT MAKING JUDGMENTS – EVEN EXPERT ONES

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One of the clear lessons from behavioral finance is that human judgment lacks consistency. Our judgment simply isn't a reliable tool for situations such as: predicting freshman performance at university; choosing the best job candidate through interviews; or, indeed, forecasting stock prices.

In this article, I'd like to discuss more of what behavioral finance tells us about making judgments, even expert ones.

According to Dr. Daniel Kahneman, Nobel laureate and author of *Thinking Fast and Slow*, human judgment almost always fails to exceed – and most often underperforms – the results of simple mathematical algorithms.

An *algorithm* is a set of step-by-step instructions for calculating a result. To provide accurate predictions, often all you need is an algorithm that takes into account only a few variables.

Kahneman gives the example of predicting the prices of certain Bordeaux wines. Red wines generally improve with age, to a point. Predicting how good a wine will be, and then how high a price it can command, is important for both vintners and for people who invest in or collect wines.

Traditionally, those predictions have been made by wine experts who combine their tastings of particular young vintages with their knowledge of grape-growing conditions and current prices.

Trouble is, their predictions aren't particularly reliable. Not because such experts don't know their wines. Rather, because they know so very much that it interferes with their accuracy.

Kahneman cites the example of economist Orley Ashenfelter, who wanted to simplify wine-price predictions. Ashenfelter created an algorithm using only three variables: average temperature over the summer growing season; amount of rain at harvest time; and total rainfall during the previous winter. Ashenfelter's algorithm provides highly accurate predictions about prices, even for 20 or more years into the future. The correlation between the algorithm's predictions and actual prices is 0.90 (where 1.00 would be a perfect correlation).

However, as Ashenfelter and others discovered, attempting to replace expert judgments with mathematical algorithms encounters significant resistance.

In the investing community, people eagerly seek expert opinions on which stocks to buy and sell, and where the market is going, especially over the short term. This happens despite the fact that, over the short term, stock fluctuations are not predictable. Even stranger, millions of trades occur every day, based on differing opinions as to whether a company's stock is currently overvalued or underpriced. Yet those differing expert opinions are presumably based on the same information about the company, such as its price-earnings (P/E) ratios, trading volumes, price history and management strengths and weaknesses.

A number of studies provide evidence that the predictions and performance of expert investors, such as fund managers, correlate poorly with actual stock prices. When these experts are asked to repeat their judgments using the same information, they often contradict their earlier judgments.

Then why do experts, and those who seek them out, cling to the notion that expert opinions are accurate?

As Kahneman explains, it is partly a distaste for replacing human activity with machines and arithmetic. It's also partly what he calls the *illusion of validity*.

Experts, after all, work hard to attain their expertise. In *Outliers*, Malcolm Gladwell reports that it takes around 10,000 hours of study and practice to gain the experience needed to be an expert in almost any field. It's not surprising that experts resist accepting judgments from a computer-run algorithm.

But perhaps, in the end, the real expert is the one who objectively determines what type of data to compute – and who can set aside biases and preconceptions when interpreting the results.



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