PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

An Excerpt from Volume 15 | Issue 4 **June 2024**

Behavioral Finance

FOOLED BY RANDOMNESS

By Stan Clark, Senior Wealth Advisor

When is your birthday? And, speaking of which, did you know that, in any random group of just 23 people, there's a 50% chance two of them will have the same birthday?

Yes, that surprised me, too. After all, with 365 days in a year, you'd assume a random group would have to be much larger to find two people with the same birthday. But, in fact, you do only need 23 people. That's because you're not just comparing your birthday to those of 22 others – everyone is making their own comparisons too. So, a group of 23 actually has 253 comparisons or chances for a matching birthday. This bumps up the odds, which at first intuitively seem improbable, to 50%.

It's hard not to think that two friends at a party finding out they share a birthday is just luck. The math says otherwise: The chance is actually counterintuitively high.

The problem with such occurrences is that they can lead us to misinterpret randomness in our perceptions and decisions.

Over the years, I've given talks on behavioral finance to a variety of groups. As part of my talks, I usually conduct an experiment. First, I ask people to imagine flipping a coin 50 times. Then, to write on a piece of paper what they think the results would be. From their imagined coin flips, we look at the longest string of heads or tails. Inevitably, every time, participants dramatically underestimate how often strings of five, six or seven heads or tails in a row would occur with random flips.

We then conduct an *actual* demonstration of 50 flips. Invariably, one or more of these long strings occur – to the surprise of everyone.

The lesson we draw from the experiment is this: We dramatically underestimate how often longer strings occur in situations that we know are purely random.

In his 2012 book *The Success Equation*, Michael Mauboussin examines the relative contribution of skill and luck, or randomness, in business, sports and investing. Mauboussin finds there is far more randomness in all these areas than most people think. Randomness plays a much bigger role than most investors believe, certainly over the very short term – but also over longer periods.

In an earlier book, *Fooled by Randomness*, Nassim Taleb discusses in detail the hidden role of chance in our lives. Emphasizing the role of luck and randomness in success, Taleb cautions against attributing success solely to skill or effort. He also discusses the human tendency to create stories that explain random events as non-random.

Understanding these concepts can help us better assess our own risks and uncertainties. I highly recommend both books.

What does all this mean for investing? Simply this. If we see a stock, mutual fund or fund manager having three, four or five years in a row of really good performance, our natural inclination is to think it's been caused by skill. Therefore, we believe it's likely to be repeated.

In reality, there's a good chance the continued good performance was in large part luck, like the toss of a coin. When you buy stocks, it's important not to put too much money into any single company. Diversification is key. And, when looking at a fund manager or investment strategy, look at far longer track records than those of just several years. Only then make meaningful conclusions.

Be careful not to get fooled by randomness.

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