

Saturday, July 31, 2010

## How to avoid costly mistakes of being human

Michael Nairne, *Serious Money*



Steve Marcus, Reuters Files

John Chambers, Cisco Systems CEO, speaks at the 2010 International Consumer Electronics Show. Cisco fell prey a decade ago to the bandwagon effect by investors.

Try your hand at this quiz: "John wears glasses and is highly detailed-oriented. Mathematics was his favourite subject in school. He is somewhat conservative, maybe even a little boring, and prefers an organized work environment. He played basketball in high school and still loves to watch the game today."

Given this profile, which is more likely?

- A. John is over six-feet tall;
- B. John is over six-feet tall and is an accountant.

If you answered B, sorry, you are wrong.

The similarity of John's description to the stereotype of accountants was likely the major influence in your answer, yet a moment of reflection demonstrates the fault in this logic. There are clearly more tall men than there are tall male accountants, so the response as to "which is more likely" should be A.

Don't feel bad. This quiz illustrates a cognitive bias called representativeness -- the tendency to make an assessment based on a stereotype or similarity.

According to behavioural finance experts, cognitive biases often distort our decision-making. For example, due to representativeness, investors often confuse well-managed companies with well-priced stocks, leading them to overpay for such companies' stocks.

A decade ago, the stock of Cisco Systems Inc. (CSCO/ NASDAQ), an exceptionally well-run growth company, soared as investors avidly pursued it. It is now trading at about US\$23 -- less than a third of its price 10 years ago.

Cognitive biases abound. One of the most powerful is the bandwagon effect -- the tendency to go with the crowd. This bias lurks behind most asset bubbles as investors get swept up in a mania and bid prices up to irrational levels.

The U.S. housing market is a recent example and prior to that, the tech boom. Incredibly, Nortel Networks Corp., now bankrupt, was once worth more than Canada's six banks combined.

Anchoring -- the tendency to be unduly influenced by a past reference point in making a decision -- is a pervasive cognitive error.

In one study, participants were first exposed to a number between 1 and 100 based on the random spin of a wheel of fortune. They were then asked whether the percentage of African countries in the United Nations was above or below that number and second, to estimate the actual percentage.

The arbitrary wheel of fortune number had a pronounced influence on the results. Participants who started with a higher wheel of fortune number ended up estimating a much higher percentage than those with a lower number.

Anchoring explains why some people selling their home get stuck on an unrealistic price. Their price perception gets anchored to an out-of-reach asking price and even when the house doesn't sell, they can't bring themselves to lower the price. Similarly, an investor will often get anchored to an earlier, high price of a stock and will hold on to it in the face of deteriorating fundamentals.

Overconfidence is another cognitive bias that can hobble investors. Researchers have found that human beings are overconfident of their skills in virtually every field of endeavour. One study found that 90% of drivers believe they are above average in their driving ability.

In my experience, overconfidence often blinds affluent investors to risks. They place too much money with a particular manager or make excessive bets by embracing a particular market forecast. They never ask themselves the question: "What if I am wrong?"

The best antidote to cognitive biases is having a comprehensive written investment plan and sticking with it. By designing and adhering to an asset mix based on one's risk profile and objectives, investors can avoid the expensive mistakes associated with simply being human.

*-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.*