Client's Corner

Beware the Confirmation Bias

FIFTY YEARS AGO, TWO ISRAELI PSYCHOLOGISTS—DANIEL Kahneman and Amos Tversky—completed a groundbreaking research paper, the central thesis of which is that people's "intuitive expectations are governed by a consistent misperception of the world."

The key word in that sentence is **consistent**. It's the notion that human behavior is not just randomly irrational but systematically so, and in predictable patterns. Years later, Dr. Kahneman (his colleague having passed away in the interim) was awarded the Nobel Prize—not in psychology but in economics!

I wrote in last month's essay—but would still like to say a bit more—about one consistently destructive unconscious bias: the hard-wired human belief that when it comes to common stocks, price and value are directly correlated.

In English, that means that when stock prices are going up, the unconscious assumption is that their value is increasing, such that investors want to buy more and more the higher they go. And when stock prices are crashing, human nature fears that their permanent value as successful companies is somehow being destroyed, and rushes to sell them at any price.

This is exactly the opposite of how we process literally everything else in our economic lives. January white sales, end of model year clearance sales on cars, Black Friday: the principle is the same. When prices are discounted for whatever reason, we perceive value as having improved, and we step up our purchases. When prices rise substantially, we pull back. As an acerbic observer named Cullen Roche wrote years ago, "The stock market is the only market where things go on sale and all the customers run out of the store."

Selling stocks after they crash is thus the ultimate unforced error in personal finance—yet it's pure human nature.

Confusing short-term prices with long-term values is thus one of the classic "consistent misperceptions of the world" in behavioral finance, but there are a number of others. Which brings us, however circuitously, to the curious case of Mr. Stanley Druckenmiller.

Mr. Druckenmiller is a billionaire, and one of the most successful investors of the modern era. His market intelligence is legendary: it was he who in 1992 brought his senior partner Mr. George Soros the idea of selling short the British pound, as he'd determined that its devaluation was inevitable. Their Quantum Fund and a few other like-minded investors fought the Bank of England, and won.

Little wonder, then, that Mr. Druckenmiller's market pronouncements are avidly reported in financial media. And, given journalism's institutional predilection for the negative, if his comments happen to be bearish, the media will even more gleefully trumpet them to the sky. Such was surely the case on May 12, when Mr. Druckenmiller told the august Economic Club of New York, and I quote, "The risk-reward for equities is maybe as bad as I've seen it in my career."

(To his great credit, Mr. Druckenmiller put his money where his mouth was. And, as the equity market surged 40%, his portfolio earned 3%. Whereupon he pronounced himself "humbled." But that's irrelevant to the point I'm making.)

My point is precisely this: I wonder how many investors—beset by the pandemic, the economic collapse and a sudden, savage 34% market crash—read this statement and said, ***"Exactly! That's just what I've been thinking! And this certified market genius confirms it!"*** And joined the rush to the exits.

This is an illustration of a particular cognitive shortcut called the Confirmation Bias. My online dictionary defines said bias as "the tendency to process information by looking for, or interpreting, information ***consistent with one's beliefs*** (emphasis added)." Like all of Kahneman and Tversky's "consistent misperceptions," it's only human.

During intensely stressful times like these, investors are under maximum psychological pressure, and legitimately fearful of making a critical mistake. At the same time, there is so much "news," data, and conflicting commentary coming at them that they can't begin to process it all. Cue the shortcut: they read a snippet of negative prognostication from a known smart person, seize on it because it validates their fears, and proceed to make The Big Mistake.

This, as I've had occasion to suggest times without number in these little essays, is exactly why your financial advisor was sent into the world. Not to predict the near-term course of the pandemic, the economy or the markets—which neither he/she nor anyone else can do, and which will probably turn out to be irrelevant to your long-term investment success. But to help you keep your portfolio aligned with your long-term goals at stressful times.

That isn't really an economic nor a financial exercise. It's entirely behavioral. It's making a plan, and sticking to it. If there is some other way to become a successful lifetime investor, I don't know what it is.