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Psychological Illusions

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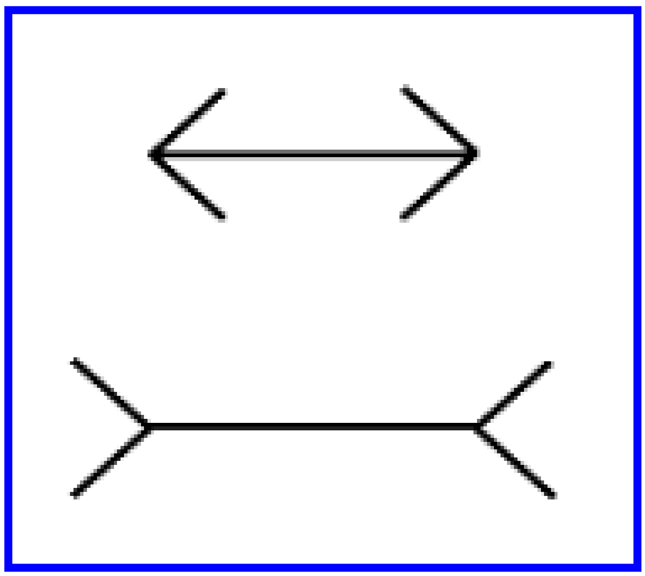
Psychological Illusions

Everyone is familiar with optical illusions: drawings that trick the brain into seeing things differently than they really are. The two lines in the box below look to be different lengths, but are actually the same; our 'eye' is tricked into seeing different lengths.



Another visual perception error involves an ink drawing that can be perceived either as an attractive young woman, or a misshapen old hag. Once you see it one way, it is surprisingly difficult to see it the other.

Psychologists know of a number of these illusions, called 'perceptual errors' in the psychological literature, that can have powerful effects on our perceptions and hence our decision-making.

Optical Illusions on page 2

Optical Illusions from page 1

I've hesitated to write this newsletter because it is much trickier to explain a psychological or decision-making error to someone than it is to demonstrate a simple optical illusion; I'm sure it's because we are so familiar with optical illusions that we don't consider them an insult to our intelligence (even though we may feel stupid when we have been tricked by them).

These errors have been given names that add to the insult: *overconfidence*, *stubbornness*, and *availability error* all seem to cut a little more deeply (to me) than two lines that look like they're different lengths. So I of course denied that I was susceptible to these illusions … until I attended an educational conference sponsored by Mackenzie Financial, where Dr. Roch Parayre, a PhD from Wharton (www.thinkdsi.com) demolished my perception, er, illusion.

Parayre assured me that being tricked by these illusions is not a reflection of faulty intellect. The illusions introduce a bias that is not eliminated by expertise. It doesn't matter how smart you are – the bias is an illusion just like the optical illusion – each time you look at the arrows you see different lengths.

The way to handle the illusions is to be aware of them. When you are familiar with them you will recognize them and be able to avoid the mistakes, just as the second time you see the arrows you recognize the trick. When you know that there is also an old hag in the picture of the young woman, it may take you awhile, but you are more likely to be able to see it.

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Assante WEALTH MANAGEMENT

Availability Bias

In this illusion, your decision is influenced by information that is readily available to your brain. The 'available' subject or idea can be as simple as a news story on a preceding page. For instance, in the ink drawing example above, if you are shown a picture of an attractive face immediately before the ink drawing, you tend to see the young woman and not the old hag.

Another example of this bias is where one group is asked to memorize a short list of positive words, such as *self-confident, adventurous, independent,* and *persistent*, while another group memorizes a list of negative words, such as *reckless, conceited, aloof* and *stubborn*. Each group then reads a somewhat ambiguous news story about a young man who they are then asked to evaluate.

Please see Availability Bias on page 3

Availability Bias from page 2

The first group thinks much more highly of the man because their perception is biased by the positive words more available to their minds. The second group, by contrast, was negatively biased by the words available to them.

Another example is from the dot-com boom of the late 1990s: a very small number of entrepreneurs, many who had worked on their projects for years, made vast sums by selling their companies. These apparently instantaneous successes screamed at us from media everywhere, leading people to believe that every dot-com company was going to the moon, when actually the success rate was very low.

According to John Allen Paulos, author of the best-selling '*A Mathematician Reads the Newspaper*', the availability bias colors our perception when two things or stories have a superficial resemblance that makes them appear analogous or parallel when they are not.

Anchoring

Related to availability is the anchoring bias. It occurs when our perspective has been set by an event or fact; we are then biased to see that event or fact as having credibility in a future situation, when it may have none.

Here's a great example from Paulos' book: a study asked people whether the population of Turkey was greater or less than 5 million; their answers clustered around 17 million. Another group was asked if the population of Turkey was more or less than 65 million; their answers clustered around 35 million. People's answers were biased, or anchored, by the number given to them. (The actual population of Turkey at the time: 50 million).

An investment example of anchoring is where an investment drops in price, say when Nortel dropped from $120 to $60. We tend to think that Nortel is a $120 stock, and it will recover. Investors will sometimes hold a stock for years, hoping for a recovery.

Paulos says that media headlines and brevity in general tend to obscure the complexity of many issues, making them seem much simpler than they really are, and beg the availability and anchoring biases. Uncritical reading of news stories tends to bolster the conventional wisdom.

The anchoring and availability biases are the foundation of advertising, because we tend to buy things that are 'top of mind'.

The anchoring and availability biases, in Paulos' words, 'slide us imperceptibly into deeper waters' because they are such dangerous tools in the hands of propagandists. If a message is repeated often enough, and not questioned, it becomes commonly accepted 'fact'. And we know from history where that can lead us.

The antidote for these biases is to always be skeptical of the prevailing view or popular wisdom, and to search for alternate explanations or ideas. Listen to both sides of the argument, and then decide for yourself.

Please see Overconfidence on page 4

Overconfidence

Overconfidence is simply the bias that leads us to be more sure of some outcomes than we should be. We tend to unconsciously believe the world is more predictable than it really is. (Surely this is the only reason anyone buys a lottery ticket.)

To demonstrate his point, Parayre gave us a little test of ten general knowledge questions. We were to answer with a high and a low number so that we were 90% sure the correct answer was within the range. The questions are:

1. Martin Luther King's age at death
2. Length of the Nile River
3. Number of countries in OPEC
4. Number of books in Old Testament
5. Diameter of the Moon in miles
6. Boeing 747 weight in pounds (empty)
7. Mozart's birth year
8. Gestation period of an Asian elephant (days)
9. Distance from London to Tokyo (miles)
10. Deepest known point in oceans (ft)

Go ahead and try the test now (see back page for answers).

What surprised me was how frequently I chose ranges that were very close to including the answer, but just slightly too narrow. For King's age, for instance, I chose 44 to 50; he was 40 when he was shot.

To pass the test, you should have only 1 miss. I got only 3 correct.

It would have been very easy for me to widen the ranges a bit and get the answers right. But I didn't. Payrayre says that even though we may have a very good idea of what the answer is, there tends to be more randomness in the actual outcome than we expect. Or in the case of this quiz, we aren't quite as smart as we think we are. Ouch!

One lesson, especially from an investment portfolio point of view, is that a portfolio should always be diversified and balanced to withstand a greater range of outcomes than we think is likely. They call them surprises for a reason!

Another lesson for the investor is that a financial plan may call for a long term average return of 8%, but in any one year the range of outcomes could vary substantially. The wise investor should ask what are the highest and lowest returns that the client could be 90% sure of experiencing in a year? Ten years?

My Lifeboat Test™ uses actual historical market data to estimate how much a portfolio could decline. I use it as a reminder that a 'bad' year is actually normal.

The Lifeboat Test™ is so valuable because it i) combats the *availability bias* by presenting additional information, ii) it avoids *anchoring* investor expectations with only the most recent (good) performance, and iii) prevents us from being overly *optimistic* by presenting a wider range of outcomes than we might have considered.

Expert Opinion

Malcolm Gladwell's top-selling book 'Blink' tries to make the point that good decisions can be made instantly. Gladwell (who was best man at my cousin's wedding) uses the example of the museum that paid millions for a sculpture, only to have a board member correctly assess it as a fake the instant she saw it.

Gladwell's mistake is in suggesting that lay people can make instantaneous judgments of the same caliber as experts. In my experience, the worst possible attribute for an investor is impulsiveness. Quick decisions beg impulsiveness.

An expert can make an instant and correct assessment – within her realm of expertise - because she has 25 years' experience. What appears to be a quick decision is actually the distillation of hundreds or thousands of similar situations.

The expert will have trained himself, possibly inadvertently, to deal with availability, anchoring, overconfidence, and the other biases. There is an expression in flying which is a *propos*: 'There's old pilots, and there's bold pilots, but there aren't any old, bold pilots'.

Fund Managers Beat the Index

The chart below was presented by David Feather, President of Mackenzie Financial, at a recent dinner. Many of my clients have significant assets invested with these managers.

Largest Global Equity Mutual Funds vs Index over 10 Years (February 28, 2007)

	Assets $ Billions	10 Year Annualized Return	10 Year Outperformance vs Index
World Index *	-	6.2%	-
Mackenzie Cundill Value C	$ 6.330	9.9%	3.7%
Trimark Select Growth	$ 6.327	8.5%	2.3%
Templeton Growth Fund	$ 5.175	5.5%	-0.7%
MD Growth	$ 4.196	6.8%	0.6%
AGF International Value	$ 3.550	8.8%	2.6%
Mackenzie Ivy Foreign Equity	$ 2.880	8.2%	2.0%
Trimark Fund - SC	$ 2.878	9.8%	3.6%
Templeton Global Smaller Co.	$ 1.920	9.7%	3.5%
CI Global	$ 1.913	6.3%	0.1%
MB Global Equity	$ 1.804	7.8%	1.6%

The chart shows that of the 10 largest Global Equity funds available in Canada. All but one either beat or equaled the index (* Morgan Stanley World C$) over 10 years to February 2007. The data is biased against the managers, since the index performance does not include any fees, whereas the manager data is net of fees.

Who says managers don't beat the index?

The real issue however, has almost nothing to do with how your managers do against an index. The unfortunate fact is that the actual return that many investors realize at the end of the day often bears no resemblance even to the managers that they are using.

As this newsletter has shown in the past (Investors Behaving Badly – Again) very few investors actually realize even the 5.5% per year over 10 years from Templeton. Why? Because they – or their advisor – don't have the patience to stay with the manager for ten years.

Clients have heard me say many times: having a good portfolio of intelligent managers is one thing, and adopting the behaviour to have success over 10 or 20 years is quite another – I love to help with both.

Socially Responsible Investing

I was pleased to be invited to a symposium on Socially Responsible Investing (SRI), also known as 'Sustainable' or 'Ethical' investing. SRI is the incorporation of environmental, social, and governance indicators into the investment process.

I have been aware of SRI issues since my first year in the business in 1980, when an old family friend, and a very experienced investor, took me aside to say he wouldn't invest in tobacco or booze companies. He said he didn't care if they made good profits, he just didn't want to have anything to do with them.

My training and experience in the pension fund world took me into risk management and diversification, manager styles and currency hedging – all highly rational and far away from soft stuff like SRI. But the world is going green with vengeance, and you ignore social responsibility at your peril ... Here's my take.

At a simple level, there are some good investment managers that use SRI screens in selecting stocks for their portfolios. If you have simple criteria, such as no booze or tobacco, and would like to discuss an SRI approach to your portfolio, please give me a call and we can set up a time to discuss it.

I must comment, however, that the investment managers that currently look after your money are already highly ethical and socially conscious people, and it is reflected in the portfolios they manage for you now.

If an investment manager detects a whiff of scandal or environmental issue about a company, they don't want the stock in their portfolio. Contrary to popular belief, environmental disasters or even mismanagement are bad for shareholders. Good profitable businesses are generally run by ethical people who have a long-term view of things, and these people naturally incorporate long-term sustainability into their business.

For example, as this newsletter reported (Enron, Worldcom et al, www.chrishoran.ca) not one manager that I use had Enron in his or her portfolio. Why? The managers that I have selected for your portfolios are the type of people who favor good, solid companies whose business model, products, services and customers they can understand.

Enron was none of those things. It was growing very fast, trading electricity and making profits that analysts couldn't understand, and the stock was going up fast. Fast bucks attract fast people who like to make their money fast, and that is usually the source of problems. I know it, and the managers know it, and we are happy to keep client money away.

If you would like to discuss any aspect of SRI, please email or call. I'd be happy to hear from you.

Answers to Quiz

1.	*age 40*	3.	*13 countries*	5.	*2,160 miles*	7.	*1756*	9.	*5,959 miles*
2.	*4,187 miles*	4.	*39 books*	6.	*390,000 lbs.*	8.	*645 days*	10.	*36,198 feet*