The Science of News

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On the plane trip back to Toronto recently I sat beside a video journalist, who makes news for a TV company. He interviewed me about the state of the global economy, and I interviewed him about the art of communications in the Twitter Age. One of the things he said was 'You have about 7 seconds to get their attention. Then you have to hold it'.

The Information Age is more dangerous to investing than you might think. A Perfect Storm of perception and behavior errors conspires against us, so that often our picture of the world can be very different from reality and we aren't aware of it. Here's how it happens.

Noisy Data is Rich Ground

Equity markets' natural daily fluctuations, frequently 1% or 2%, are statistically large in the context of our expected long term returns. These fluctuations are random statistical noise with very little information.

Sometimes statistically useless noise is entertainment, like watching sports on TV. But investing is not benign entertainment; investing is dangerous.

Today, unlimited data points race to fill our view, capturing our attention for a second or two, but they damage our ability to see - like snowflakes in front of our windshield at night.

The human mind does not handle large volumes of data well. Over short timescales, you see the noise, not the signal. Paradoxically, the more we look, the less we know. Only over time does the variability cancel out and the trend become apparent.

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But it's more than just noise. In *Fooled by Randomness*[1] Nassim Taleb shows how even with a portfolio that does well long term, when we shorten the timescale to one day, the probability of a positive return is only 54%. A week isn't much better.

A hypothetical investor who watches his portfolio daily will, being human, find that a positive return in one day gives him a shot of pleasure, while a decline the next day brings pain.

Humans feel twice as much pain from a financial decline as pleasure from an equivalent positive event[2]. This emotional asymmetry means our investor will experience a serious emotional deficit. His confidence will be drained – simply from looking at noisy data.

The Narrative Problem

A data point registers more strongly in our consciousness when it fits into a narrative or story[3]. The story helps us recall the point (even if it is incorrect). This means the negative psychological effect of random fluctuations is reinforced by the narrative supplied and amplified by daily news media, which loves the negative.

Humans' instinctive sensitivity to danger, programmed on the African savannah, is amplified today by the nightmare of 2008/9. Just as my teenage son had to sleep with the light on for a week after seeing The Exorcist, investors' nerves are sensitized by the financial crisis: nobody wants to live through 2008/9 again.

But it's more dangerous than 'bad news sells'.

Noisy data is rich ground from which to pull a story. The noise camouflages the trend and provides cover for selective observations, which in turn play on our genetic sensitivity to danger signals, and leave us exposed to fabricated or exaggerated danger.

Consider the following headline one morning on my Bloomberg data service: '***Stocks rise on hopes of Euro agreement***'. Then a second headline, from the same Bloomberg: '***Stocks fall on fears of Euro member default***'. The second one appeared two hours after the first. I'm not making this up.

These headlines demonstrate both the futility of trying to gain insight by watching closely – stocks up, stocks down, Euro this Euro that – and also how a trivial data point is given weight by fitting it anecdotally into a narrative, in this case, the Euro saga.

Placing a random market fluctuation into the Euro narrative infers a cause and effect relationship where frequently none exists. It is highly unlikely – impossible even – that the news source has a credible scientific basis supporting the claim that Euro announcements have caused the markets to move up one hour and down the next. It's a random market fluctuation.

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[1] From 'Fooled by Randomness', Nicholas Nassim Taleb, 2004; a great book about 'The hidden role of chance in life and the markets'.

[2] Daniel Kahneman, 'Thinking, Fast and Slow', 2011, also Kahneman and Taversky 'Judgement under Uncertainty', 1974; this is the landmark paper on decision making heuristics and biases.

[3] The Narrative Fallacy, see The Black Swan, Taleb, 2010.

Much of the time the blogger or journalist just sticks together two coincidental events and fits them into whatever he wants the story to be that day, such as 'Equities falter on growth doubts', or 'Pound falls on BOE minutes', or 'Builders brittle as data dampens recovery hopes'[4]. Any downtick in December 2012 was reported as 'Stocks fall on Fiscal Cliff fears'.

In some instances news may be important, but you don't know for sure – the 23% crash October 19, 1987 was caused by computer program trading, not by any economic data. The biggest one-day decline in history was just a very loud noise[5].

The point is that a random market fluctuation that happens to coincide with a news event assumes a cause/effect relationship whether it is justified or not. The instinct connecting the two is so powerful we have trouble believing that there may be no connection.

Public Perception at Odds with Reality

Life as Reality Show

Not only did the Fiscal Cliff Terror have the world needlessly on edge[6], take for example the Globe and Mail headline: ***'Experts, Public at Odds Over Economy'***. I quote:

'*Economists and the Bank of Canada have been telling Canadians the country has been out of a slump since mid-2009, and is now well into a period of expansion. But Canadians see things differently. Despite the economy's relative strong health in a world marked by tumult, they are the most pessimistic they have been in over a decade – and* ***fully 70 per cent believe the nation is still in a recession****, according to an annual tracking poll released Thursday.*'[7]

It is stunning to me that the public could incorrectly perceive that we were still in a recession, even after 2½ years of actual growth. A recession is a simple matter of fact. The public's misperception is attributed to the 'ample bad news', even though Canadians 'have been told' by economists and the Bank of Canada that the economy is growing. But the irony – that article of course neglects to acknowledge - is the public's incorrect perception is largely formed by … news media.

Which begs the question: if the news media can portray the fact of 2½ years of economic growth so that 70% of the public thinks we are still in a recession, what does that say about the media's presentation of other issues such as the Euro crisis, free trade, the benefits of free enterprise, or other important narratives?

The news media's glorification of the anecdote has us living in an increasingly virtual – and negative - world. It goes way beyond 'bad news sells'. It is more subtle, pernicious, and powerful[8]. The endless repetition of the negative narrative forms a classic perception error - called an 'Availability Cascade' - so that many people today have trouble seeing a positive future.

The Trap

Our hypothetical investor is falling into a trap: emotionally fatigued by noisy data, the constant negativity of the news cycle plays on his instinctive sensitivity to danger, eroding his courage to withstand actual bad news when it inevitably occurs, and making him more likely to flee the markets when he shouldn't.

Worse, he will not be aware of his emotional deficit. Feeling informed by data, he may actually consider himself astute and up-to-date. He will watch stock quotes during his holiday, and will actually know whether the market has gone up or down at the end of the day.

The trap is being set.

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[4] Headline examples from Financial Times, January 19, 2012 and February 28, 2013.
[5] The crash of October 1929 was of similar magnitude but occurred over two days.
[6] See the December 2012 newsletter www.chrishoran.ca which said the cliff was not likely to be a problem.
[7] Globe and Mail, January 6, 2012, my emphasis added.
[8] A Mathemetician Reads the Newspaper' by John Allen Paulos is one of the first and best books about misleading information in media.

What makes the trap so deadly is the investor thinks he is well-informed and rational. This feeling of being more informed than you actually are, called 'Overconfidence', is one of the classic perception errors[9], and is behind many of the greatest investment mistakes investors make. I see it all the time.

The Tech Stock Crash, the Asian Currency Crisis, the US Trade Deficit Terror, the Y2K Bug, the Fiscal Cliff Fears, or whatever the Apocalypse Du Jour happens to be, all are blown out of proportion, taking the more fragile investors over the cliff of the Big Mistake.

Misplaced Confidence (and its mirror, Misplaced Fear) are information errors. You think you are being smart, but you are missing something and you don't know it. The Black Swan surprise of Thanksgiving Dinner is a surprise to the turkey, not to the turkey farmer[10].

How to Handle Noise

The first step is to turn down the noise. Hit the mute button. Stop chasing data.

If our hypothetical investor were to look only at his monthly statements, his emotional deficit would improve dramatically: market volatility in Taleb's example translates to 8 positive months and 4 negative months in a year. And if he were to look at his portfolio only during his annual review with his investment advisor, he would experience 15 positive years out of 20.

Professional and experienced investors are less likely to fall victim to the noise, narrative, and other perception errors for two reasons. First, pros have some knowledge of the financial and economic machinery so that we have some small hope of distinguishing important from trivial in the torrent of data.

Second, pros and experienced investors know about the perception errors such as overconfidence, and consciously correct for them. Pros are always testing their views, thinking of assumptions that may be incorrect, looking for things they may have missed. Chastened by often painful mistakes, pros are never certain, because in investing, certainty is the kiss of death.

Where Shall Wisdom be Found?[11]

This leaves us with the question of how can an investor gain knowledge about investing?

Margaret Atwood was on an airplane, sitting next to a surgeon. When he found out who she was, he said, 'Oh that's great! When I retire, I'm going to write a novel'. To which Atwood apparently replied, 'That's interesting. When I retire, I'm going to become a surgeon'.

Clients know, and bless you all for it, that many things in life look simple only when you don't know much about them. Or, as Robert Pirsig wrote in 'Zen and the Art of Motorcycle Maintenance', things become simple only after you've figured them out.

Ideally, of course, you would read my newsletter. And circulate it to your friends.

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[9] 'Overconfidence', see Kahneman and Taversky, and also 'Psychological Illusions' April 2007, www.chrishoran.ca.
[10] See 'The Black Swan' www.chrishoran.ca newsletter archives.
[11] This heading is borrowed from a wonderful little book by Harold Bloom, "How to Read and Why". If you would like to gain investment wisdom, email me and I'll send you my reading list.

The Irony

The irony of it all is that many of the biggest decisions – and mistakes - are made with information that is widely available, but people do not want to see. It was no secret that the tech stocks, for instance, were trading at impossible multiples, yet many people did not want to see the danger.

It is no secret that bonds are yielding less than inflation, thereby guaranteeing a loss of purchasing power. It is a fact that bonds will fall in price when interest rates rise. It is no secret that interest rates *will* rise, because Ben Bernanke will print money until they do; yet many people are piling into bonds because they are still terrified of stocks (and they do not know the history of the 1970s).

It is also no secret that US economic output has surpassed 2007 levels and unemployment is within a hair's breadth of its pre-crisis low, telling us the world is moving ahead.

Successful investing is not about rapid trading or lowest cost; it is not about inside information, or even high returns. Successful investing results from focusing on specific goals, having a well-considered plan, a portfolio design combining tested principles yet cognizant of the current situation, and avoiding Big Mistakes.

Full Circle to the Trend

This brings us full circle to market data and the trend. When we strip away the daily, weekly and monthly variability of the market, what is the trend?

Today's US trends are positive. While the news media focuses blindly on the last recession, important equity market sub-indexes have broken significantly through their previous highs of 2007. The S&P 500 equal-weight index, the consumer durable, consumer discretionary, midcap and technology sub-indexes are all more than 10% over their 2007 highs[12].

Since consumer spending is about 70% of US GDP, these new highs tell us that the major machinery of the US economy is operating normally, and the recovery from 2009 continues.

Longer Trend

Last October was the 25th anniversary of the scariest day in investment history – October 19th, 1987[13]. I was there. The S&P 500 fell about 23% that one day, closing at 225 points, according to Nick Murray, industry veteran and advisor. Today the S&P500 is at 1550 points, give or take.

This gain represents a 25-year increase of almost 7-*fold*. A 7-fold return in 25 years works out to 8% per year. Including zero in the last 12. Longer term, from 1926, the return is about 10%. That's the trend. Everything else is noise.

[12] Market data from BigCharts/MarketWatch.com
[13] The crash in October 1929 took 2 days, and the Depression hadn't happened yet, so wasn't as scary.

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Book Review – The Righteous Mind

Jonathan Haidt
Random House 2012

Once in a while a book comes along that can really change our understanding. This is one of those books. It is both scientifically robust (27 pages of references and 50 pages of notes) and eye-opening in its implications.

Psychologists are able to discern, through closely designed experiments such as 'Prisoners Dilemma', subtle differences in the way people perceive things. Haidt describes 6 'foundations' or building blocks of moral thought: Care, Liberty, Fairness, Loyalty, Authority, and Sanctity. Each block exists to varying degrees in all humans, and the spectrum (or yin and yang) of each block gives us our fascinating combination of 'groupishness' and individuality.

Haidt shows how individuals on the political left and the political right see issues slightly differently in terms of the 6 foundations. He shows how we can improve our understanding of people whose ideas seem so anathema (or stupid) to us, and of course, how even those on the other side of the political spectrum aren't that much different from ourselves.

For example, the moral foundation block of 'Fairness/Cheating' relates directly to the law of karma, which sees an outcome as fair if it is proportional to the input. Reap as you sow, and the fable of the Little Red Hen, who got to keep her bread because the other animals had refused to help her bake it, are examples of karma.

Experiments show that people with conservative or 'right wing' views tend to see fairness more in terms of this karma or proportionality of input, whereas leftists, who tend to be sensitive to the 'Care' foundation, see fairness more in terms of equality of outcome.

The reason leftist efforts at equalization drive conservatives bananas is because conservatives tend to be sensitive to the 'loyalty/betrayal' foundation. This means conservatives see society as a beehive, where everyone must do their part for the hive to survive; conservatives are terrified that equalization rewards those freeriders who haven't contributed (cheating), thus weakening (betraying) the hive and endangering its survival.

Both sides of the political spectrum need to recognize the yin and yang in each of the foundations. Each side has perfectly valid points to make (cheating does weaken the hive; some individuals do need help bouncing back), and by recognizing each other's valid points, the common ground can be found.

Jonathan Haidt is a social psychologist, and Professor of Ethical Leadership at New York University Stern School of Business.

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