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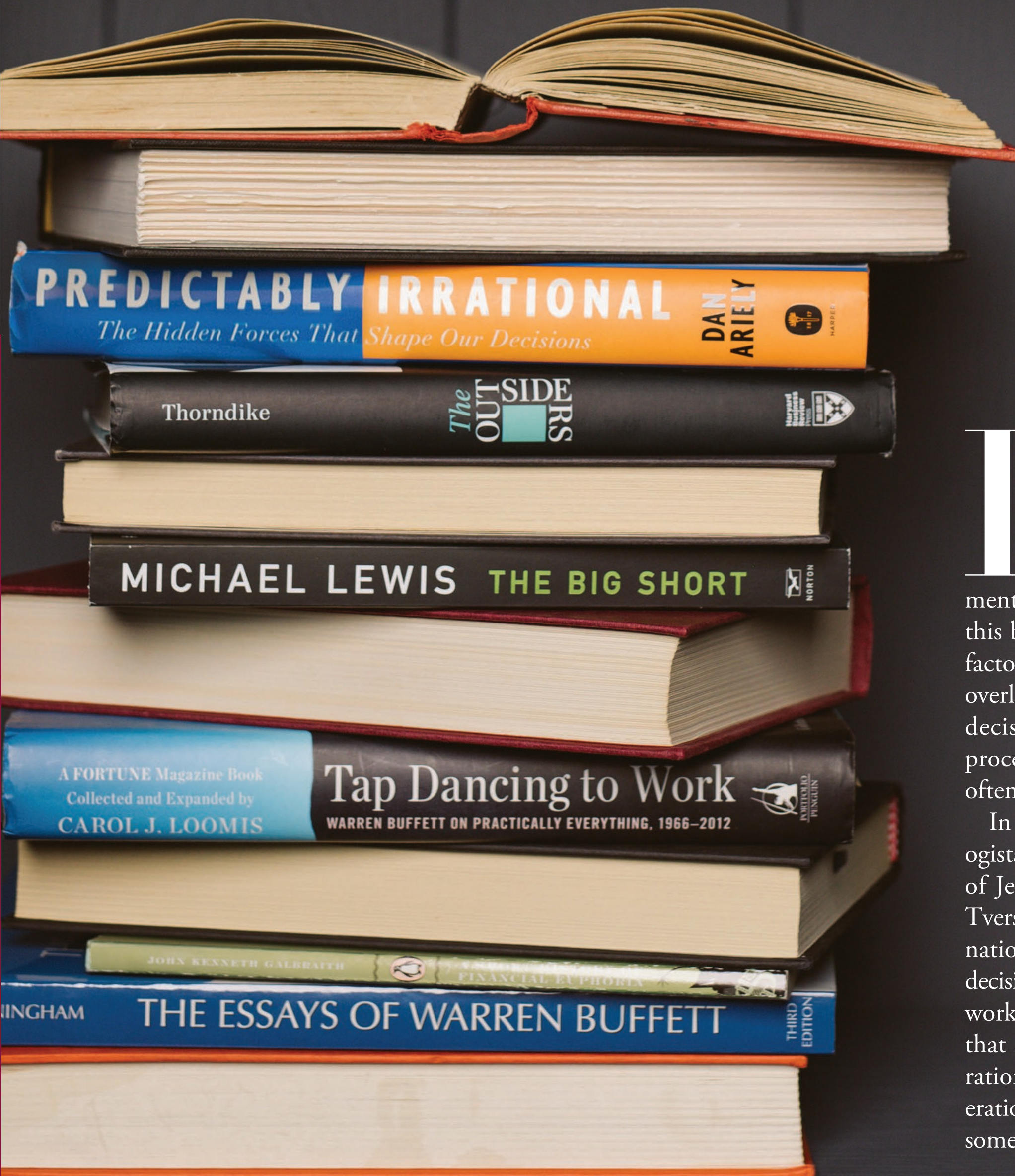
Predictably Irrational: The Hidden Forces That Shape Our Decisions

By: Angela Bhutani & Roz McLean



In the typical path to becoming a better investor, most people spend their time understanding financial concepts such as how to interpret a company's financial statements or learning about investment products available to them. While all of this background may be useful, there is a key factor in the investment process that is often overlooked: understanding the psychology of decision-making. The best-laid investment process can be derailed by emotion, and too often, profoundly alter the desired outcome.

In the 1970s, two Israeli-American psychologists and professors at the Hebrew University of Jerusalem, Daniel Kahneman and Amos Tversky, studied and explored the human inclination to hold psychological biases that affect decision-making. Prior to their ground-breaking work, conventional economic theory dictated that humans were rational beings who made rational decisions based on economic considerations such as cost and utility. Their work was some of the first academia to marry the fields of

Clockwise from above: Kate Mostowyk, Investment Counsellor; Marie-Noël Henri, Montreal Office Manager; Sandy Whitehouse, Executive Assistant; Lisa Ritchie, Vice President; and Rachel Davies, Investment Counsellor.

psychology and economics, and would go on to earn a Nobel Prize. Although the field of behavioural economics is still relatively young, Kahneman and Tversky's seminal ideas have attracted much attention, particularly in the investment industry. The Chartered Financial Analyst (CFA) Institute, which prepares future analysts and investment managers, now dedicates a part of its curriculum and a section of its final exam to the subject of behavioural biases. The introduction of behavioural economics into mainstream financial education programs, such as the CFA program, reflects a recognition that entrenched biases can lead us to make imperfect or irrational economic decisions. In becoming aware that our biases exist, we come one step closer to being able to control them.

Predictably Irrational, written by Dan Ariely and inspired by the teachings of Kahneman and Tversky, brings to light common patterns in our decision-making processes through Ariely's experiments as a professor and researcher at Duke University.

While not all of the biases discussed in *Predictably Irrational* relate to investment behavior, we will address a few that do.

Chapter 1: The Truth about Relativity

Ariely highlights our tendency to evaluate things not on their own merit, but relative to other things presented alongside. Ariely believes that we create or diminish our perception of value through comparison, which can lead to irrational, non-optimal decisions.

To further explore the truth about relativity, consider the following question: how happy would you be if you earned a return of 20% on your equity investments over one year? Most of us would be pretty happy with this figure.

What if I now tell you that in this same year, the market had a return of 63%? Does this change how satisfied you are with your 20% return?

For the twelve-month period ending August 31, 2000, the TSX/Composite Index was up 63%. Market returns were driven by sky-high valuations among technology companies. In Canada, a single large technology and telecommunications company (Nortel Networks) had a spectacular one-year return of 292% and came to represent a third of the Canadian stock index.

Many value investors had decided against investing in Nortel based on weak business fundamentals. When the clients of these value investors compared their returns to the market index, some were quite unhappy with the relative underperformance. By the end of 2001, the market realized that the future earnings of many technology and telecommunications companies were grossly overestimated. A crash in prices ensued, which is often referred to as a bursting of the "tech bubble."

How do we evaluate our satisfaction with independence and resist the bias toward relative judgement? We suggest writing down your investment goals. Define your needs, return expectations and the level of risk you are willing to tolerate. This will guide you to an absolute benchmark and will help you assess how your strategy is helping you achieve your goals over time.

Chapter 8: The High Price of Ownership

In chapter eight, Ariely addresses the phenomenon of "The High Price of Ownership." He says that "as soon as we begin thinking about giving up our valued possessions, we are already mourning the loss."

Ariely also teaches us that "ownership" is not limited to material things. It can also apply to points of view. Once we take ownership of an idea, we have a tendency to value it more highly than it is worth and feel a loss when letting it go.

In economics and psychology, loss aversion is an observed phenomenon where the pain of loss is greater than the pleasure of equivalent gains. This asymmetry is grounded in our evolutionary history. Organisms that treat threats as more urgent than opportunities have a better chance to survive and reproduce.

So what does this mean for us as investors? How do we combat this bias?

As investors, it is important to practice open mindedness and to seek ideas that might break our investment thesis, rather than searching for information that confirms it. This practice of impartiality towards our own ideas can help us more accurately evaluate an investment's economic value rather than its emotional value to us.

Chapter 9: Keeping Doors Open

"Keeping Doors Open" focuses on time spent nurturing opportunities that might distract us from our main goals. Ariely explores the cost of keeping doors open in a literal sense through an experiment called "the door game." In this game, participants had the choice to stay in one room, or move from one room to another. Participants often chose the latter, even though the highest payout and success would be achieved by staying in one room. This experiment is meant to illustrate our tendency to keep doors open rather than staying focused on achieving our objectives by sticking to just one strategy—or to one room in this case.

Ariely compares this experiment to the predicament of one of his students who is having trouble closing the door on an old boyfriend. Even though she clearly likes her new boyfriend better than the old one, she can't let the old relationship go.

Underlying each of these problems is the issue of scarcity. When making decisions, we have limited time and money. We are often challenged—not by a lack of opportunities to spend our time and money, but by an abundance of them. This is especially true in investment markets where there are hundreds of thousands of potential investments and an endless amount of research that could be done on any given investment. In a predictably irrational way, we often seek to keep many opportunities open at the expense of pursuing one strategy vigorously. The fear of missing out overpowers gains that might have come from being focused.

To combat this bias, we must appreciate and harness the power of focus. In an investment context, this might mean narrowing the broad opportunity set of over 2400 companies publicly listed on the New York Stock Exchange to a more manageable subset. This will allow for depth of knowledge.

Ariely's book helps investors realize that in order to begin combating our behavioural biases, we must first be aware of them. Awareness of our own limitations requires humility and discipline—two key ingredients in the investment process and in life itself. **M**

FURTHER READING:

Misbehaving: The Making of Behavioral Economics
by Richard H. Thaler

The Little Book of Behavioral Investing: How Not to Be Your Own Worst Enemy
by James Montier

Thinking, Fast and Slow
by Daniel Kahneman