The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

How emotions and biases affect our finances

By Stan Clark - Senior Investment Advisor

One of the most fascinating things ever to happen in economics was when an ingenious psychologist, Dr. Daniel Kahneman, decided to study it. In 2002 he won the Nobel Prize in economics for "having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty." Kahneman actually created a new discipline, Behavioral Finance. In fact, his latest book *"Thinking, Fast and Slow"* was one of the New York Times top five non-fiction books of 2011.

What Kahneman discovered was shockingly contrary to the long-cherished beliefs of finance and economics: markets and the economy in general, are anything but efficient or rational.

Kahneman, and others since, have repeatedly shown that when it comes to matters of economics, finance and investing, people (including professionals) make systematic, repeated mistakes, are seldom aware of their mistakes and fail to learn from them.

Behavioral Finance explains the tech boom of the 1990's, the real estate boom of this past decade, and their corresponding busts. If more of our political and financial leaders were familiar with Behavioral Finance, it could have helped to prevent these.

For individuals, it explains recurring mistakes people make with their investing, borrowing, spending, and other crucial areas of their finances. Becoming more familiar with Behavioral Finance can help you avoid these mistakes, and benefit from the mistakes of others.

Kahneman's major discovery was that emotions and biases have far-reaching effects on our judgments and decision making. No matter how smart, educated or professional you are, emotions and biases affect everybody because they have been hard wired into our brains over millions of years of evolution.

Here are a few ways our emotional brains get in the way of good judgment:

- People are overconfident when making predictions ("home prices will always rise"). Confidence increases as we collect more information; unfortunately, forecasting accuracy does not.
- We have a strong "hindsight bias" leading us to believe the future is easier to forecast than it is. However, accurate forecasting is extremely difficult because our economy is so complex and because creativity, innovation and competition are things that simply cannot be forecast.
- People place more confidence in complex explanations than simple ones. But simple often turns out to be better.
- We evolved as story tellers: people are more comfortable with anecdotal data and stories than with facts, figures, and statistics. This causes us to be persuaded by a good story, even when the numbers don't add up.
- People are uncomfortable going against the crowd. We evolved as social animals and naturally feel comfortable staying with the group, even when the group is going where it shouldn't.
- People place far more weight on recent events and personal experiences, than on long ago events and the collective experiences of others. That is why we never seem to learn from history.
- We filter and process information selectively, giving more weight to information that confirms our emotional biases: we see what we want to see, and often ignore uncomfortable facts.
- We are far more strongly influenced by our emotional brain than most realize. Often our rational brain makes up arguments so we will believe what our emotions want us to believe.

The consequences of our all-too-human tendencies are significant, especially when dealing with finances and investments. Behavioral Finance is a huge and important topic that affects all of us every day. It's a fascinating area and I invite you to learn more about it.

Stan Clark is First Vice-President, Portfolio Manager and Senior Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

To learn more about CIBC Wood Gundy, the Stan Clark Financial Team and the many ways we can help manage your wealth, please contact us by phone or by email as listed below.

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