# Commentary

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## Behavioral Finance: Hindsight Bias

- When reflecting on a past event, some people overestimate their ability to have predicted its outcome.
- Hindsight bias alters memories, allowing people to selectively recall things they now know to be true.
- Overcoming hindsight bias can strengthen decision-making and help prevent investors from repeating errors.

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We've all heard the saying that hindsight is 20/20. From sporting events to legal trials and political elections, people commonly assert that they expected the outcome all along — even if they really didn't. This is not a matter of dishonesty; rather, according to psychologists, it's a matter of *hindsight bias*.

This kind of inflated sense of foresight that can develop in the aftermath of an event also occurs among investors when reviewing their past decisions. This has been observed by behavioral finance experts who combined cognitive psychological theory with conventional economics and finance in an attempt to explain the reasons behind irrational financial decisions.

**Hindsight Bias**

Our sense of reality can be prone to hindsight bias when seeking order in the seemingly chaotic world of financial markets. This happens when our brains naturally blend memory distortion with beliefs about the objective likelihood of an event and confidence in our personal ability to predict a given outcome. The resulting hindsight bias acts as a filter that allows our brains to process the unfolding of events in a way that makes sense to us, leading us to believe that the results were predictable, logical or even obvious — conveniently providing a way to avoid blame when our assessments turn out to be wrong.

In his book *Thinking, Fast and Slow*, psychologist Daniel Kahneman, one of the founders of behavioral finance, writes "a general limitation of the human mind is its imperfect ability to reconstruct past states of knowledge, or beliefs that have changed. Once you adopt a new view of the world…you immediately lose much of your ability to recall what you used to believe before your mind changed" (pg. 202).

Remember when the U.S. housing bubble burst in 2007? Homebuyers with less-than-desirable credit eagerly committed to mortgages that were far beyond their means, as they got swept up in the wide availability of sub-prime loans and believed that real-estate prices would continue to rise. In retrospect, it's easy to claim that the impending collapse had glaringly obvious red flags; but at the time, in the midst of the rush to buy, it would have been difficult for most of us to recognize.

**Avoid the Trap**

Hindsight bias can cause us to be overconfident in our judgment, leading us to think we can predict the future based on events from the recent past. It can also prevent us from learning from experience and from examining the reasons that something happened.

From a financial perspective, hindsight bias can cause us to take on more risk than might be appropriate for our tolerance level and investment objectives. One way to avoid falling prey to hindsight bias is by performing a thorough analysis of your investment decisions prior to taking action — and trying to recognize the full range of associated potential outcomes.

Another way to avoid hindsight bias is by taking notes of your investment decisions as you make them, and reviewing them immediately after the actual outcome is known. This may help preserve the accuracy of your memory when it comes to understanding why you took certain actions, and allows you to assess the quality of your decision-making process.

As always, evaluating your investment decisions and aligning them with your goals can help you overcome the potentially harmful effects of hindsight and other biases.

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