Commentary

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Behavioral Finance: Confirmation Bias, Cognitive Dissonance and Recency

- Confirmation bias occurs when we selectively collect evidence that overvalues or supports our claims or beliefs and minimizes contradictory evidence.
- Cognitive dissonance occurs when newly acquired information conflicts with pre-existing understandings, causing discomfort.
- Recency relates to our ability to recall information that appears at the end of a list of complex data, rather than that which appears earlier.

In our last installment, *Behavioral Finance: Optimism and Overconfidence*, we discussed inherent biases that can adversely impact investor decisions. The field of behavioral finance, as it is known today, originates from Daniel Kahneman and Amos Tversky's (K&T) ground-breaking research of behavioral economics and finance, which legitimized this field of study and paved the way for additional analysis and theories.

In this segment of our Behavioral Finance series, we will examine confirmation bias, cognitive dissonance and recency, additional behaviors that may lead us to make investment mistakes.

Confirmation

The subconscious confirmation bias occurs when we selectively collect evidence that overvalues or supports our claims or beliefs, while minimizing or ignoring evidence that contradicts them. For example, when we buy a new car, we want to believe that we made the smartest decision. To support that belief, we often seem to notice the model that we just bought at a higher frequency than before.

Daniel Gilbert, author of "How Mental Systems Believe"[1] asserts that understanding a statement must begin with an attempt to believe it. Daniel Kahneman, author of "Thinking, Fast and Slow" thinks that the attempt to believe explains confirmation bias. He states, "You must first know what the idea would mean if it were true. Only then can you decide whether or not to *unbelieve* it."[2]

1. Gilbert, Daniel. "How Mental Systems Believe." *American Psychiatrist.* Volume 46, Number 2, February 1991.

2,3. Kahneman, Daniel. *Thinking, Fast and Slow*. Penguin Books Limited, ©2011. p. 81.

Further, Kahneman states that the initial attempt to believe is an operation of System 1, the automatic and effortless thinking process. However, deciding whether to unbelieve requires the deliberate employment of System 2, the more effortful thinking needed to refute an idea.[3]

Confirmation bias can occur when our portfolio is highly concentrated in the stock of a company where we work. As an "insider," it is easy for us to see evidence of success at our firm and justify our decision (e.g., "Everyone got a raise this year," or "We are making big plans for next year"). While a highly-concentrated investment is sometimes justified, the risk-reward profile of a highly concentrated portfolio is much likelier to produce more volatile returns than a diversified portfolio.

To address confirmation bias, we must be aware of when System 1 has been engaged and understand that our thinking has shifted into auto-pilot. We can then tactically combat confirmation bias by actively seeking information that refutes our ideas or beliefs. By understanding that there are rarely flawless investment ideas, we can refuse to act on any idea until we have considered it against sufficient contradictory information.

Cognitive Dissonance

Prolific behavioral finance author Michael Pompian notes, "When newly acquired information conflicts with preexisting understandings, people often experience mental discomfort…cognitive dissonance."[4] Cognitive dissonance partially explains the reasons why we

4. Pompian, Michael. *Behavioral Finance and Wealth Management, How to Build Optimal Portfolios that Account for Investor Biases*, *2nd Edition*. John Wiley & Sons, Inc. ©2012. p. 81.

succumb to confirmation bias; confirmation of our beliefs prevents or relieves mental pain.

An example of this can be seen when we make investment decisions that result in losses and often rationalize to relieve dissonance. However, rationalizing to ease cognitive dissonance (e.g. “My broker bought it for me.” or “Its stock price hit new highs, so everyone thought it was a good bet.”) prevents us from learning how to avoid similar mistakes.

To overcome this, Pompian suggests that we address the feelings of unease at their source and take appropriate *rational* action, rather than adapting beliefs or actions to circumnavigate cognitive dissonance.[5]

Recency

Recency bias is similar to availability bias as it relates to our ability to recall recent information more easily than information obtained further in the past. For example, consider our ability remember items that appear at the end of a long list of complex data, rather than those that appear earlier. Market data can include long lists of complex information and many investors do not have systems in place to automatically capture important data points dating back several years. In addition, we may not place sufficient weight on older data points even if we do capture the data.

In early 2000, after four years of a raging bull market in technology, media and telecom stocks that lifted the entire stock market to new highs, it was easy to convince investors—professional and amateur—that it was “different this time”; and that despite the experiences of past boom and bust cycles, stocks lifted amid the tech frenzy would continue to rise unabated. This, of course, was not the case, and the tech bubble deflated in a tragic spectacle.

Investors can counter recency bias by remembering that long-term relationships usually hold up for good reason. For example, there is a long-term relationship between the cash flow that a firm can deliver and the stock price it supports. That relationship will not vary by large degrees for long periods of time; and eventually the relationship will regress toward the mean. Today, one relationship that appears to have been moving toward an extreme for a fairly long time is the share of corporate profits as a percentage of revenues—the corporate profit margin. Investors need to ask whether it’s truly different this time.

Conclusion

Confirmation bias, cognitive dissonance and recency are behavioral patterns that we call on to alleviate discomfort, affirm our beliefs and access information when making investment decisions. However, relying on these automatic and almost reflexive behaviors as the sole basis for decision-making will set us off course. The good news is that, once recognized, they can be tested with additional information to confirm their validity.

In our next and final paper, we will recap the behaviors and biases that can lead us to make misinformed investment decisions. We will also touch upon what benefits, if any, investors can draw in efficiency terms from these behaviors when navigating information-rich subjects (such as financial data).

5. Pompian, Michael. *Behavioral Finance and Wealth Management, How to Build Optimal Portfolios that Account for Investor Biases, 2nd Edition*. John Wiley & Sons, Inc. ©2012. p. 81.