Is Your Hindsight 20/20?

by Sheldon McFarland

"I knew it all along." – All of us, at some point

I recently came across a 1998 newsletter piece about hindsight bias by Meir Statman, Glenn Klimek Professor of Finance at Santa Clara University and long-time Loring Ward Investment Committee member. What Meir wrote in 1998 is just as true today.

He wrote about a physician who came to him for investment advice in December 1994.[1] The physician worked hard and saved diligently for many years, and by his late forties had a nice nest egg. It was all in U.S. Treasury bills and he was seeking a better way to invest. The man was considering U.S. stocks but lamented, "The stock market is so high! It is bound to crash."

He was right, eventually it did crash! It crashed in 2000 and the precipitous decline continued through 2002. And then it crashed again in 2008. Knowing that, and everything else that occurred over the last 20 years, what would you have told the physician? Even with hindsight it might not be so clear.

I think Meir's response was perfect; it was beautiful. He told the physician that he didn't have the slightest idea where the stock market was going over the next three, five or even 10 years. "But," he said, "I rely on good evidence when I say that stocks, foreign or domestic, are likely to do better than Treasury bills over the long run." And he was right too.

U.S. stock growth skyrocketed past U.S. Treasury bill growth. Consider this: one dollar invested in the S&P 500 Index at the start of 1995 grew to $7.88 by the end of March 2017 vs. $1.69 for One-Month U.S. Treasury bills over that time.*

[1] Statman, Meir, Hindsight Bias, Newsreporter, Spring 1998

With 20/20 hindsight we would now look back and confidently say that investing in the stock market was the better choice. *But what about the surprises that happened along the way?* As Nobel Laureate Daniel Kahneman says, “Hindsight bias makes surprises vanish.”[2]

Most of us never get to that point where we can say our hindsight is no longer 20/20. When the next market correction occurs we’ll probably say we saw it coming and if it doesn’t occur anytime soon, we’ll say we knew that too. That’s what hindsight bias is — it’s the impulse that insists we knew it all along. People with hindsight bias tend to perceive that an event was predictable, even if it wasn’t. This happens because outcomes that occur are more easily grasped by our minds than the infinite number of outcomes that didn’t occur. Basically, once an event occurs it becomes obvious, but that is because we can’t completely comprehend all the possible outcomes.

The biggest implication for investors is that hindsight gives a false sense of security when making investment decisions. We hate uncertainty and hindsight bias is one way we eliminate that uncertainty — albeit falsely. This can result in excessive risk-taking behavior because you perceive events to be certain when they aren’t and this untamed risk can jeopardize your portfolio. The “wise” investor living with uncertainty, as Meir counseled in 1998, chooses a well-diversified portfolio, one that contains a mix of investments — stocks and bonds — from around the world.

Diversification neither assures a profit nor guarantees against loss in a declining market.

**Past performance is not a guarantee of future results. Hypothetical value of $1 invested on January 1, 1995 and kept invested through March 31, 2017. Assumes reinvestment of income and no transaction costs or taxes. For illustrative purposes only and not indicative of any investment. Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Stock investing involves risks, including volatility (up and down movement in the value of your assets) and loss of principal. Treasury Bills are backed by the US government and are subject to interest rate and inflation risk. Treasury Bill values will decline as interest rates rise. The value of the U.S. dollar depreciates over time with inflation, so the primary risk is inflation risk.*

[2] Zweig, Jason, Your Money and Your Brain, Simon & Schuster, 2007

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