Confirmation and Hindsight Biases

Psychology of an Investor

It is often said that "seeing is believing." While this is often the case, in certain situations what you perceive is not necessarily a true representation of reality. This is not to say that there is something wrong with your senses, but rather that our minds have a tendency to introduce biases in processing certain kinds of information and events.

In the following, we will discuss how confirmation and hindsight biases affect our perceptions and subsequent decisions.

Confirmation Bias

It can be difficult to encounter something or someone without having a preconceived opinion. This first impression can be hard to shake because people also tend to selectively filter and pay more attention to information that supports their opinions, while ignoring or rationalizing the rest. This type of selective thinking is often referred to as confirmation bias.

In investing, the confirmation bias suggests that an investor would be more likely to look for information that supports his or her original idea about an investment rather than seek out information that contradicts it. As a result, this bias can often result in faulty decision making because one-sided information tends to skew an investor's frame of reference, leaving them with an incomplete picture of the situation.

Consider, for example, an investor that hears about a hot stock from an unverified source and is intrigued by the potential returns. That investor might choose to research the stock in order to "prove" its touted potential is real.

What ends up happening is that the investor finds all sorts of green flags about the investment (such as growing cash flow or a low debt/equity ratio), while glossing over financially disastrous red flags, such as loss of critical customers or dwindling markets.

Hindsight Bias

Another common perception bias is the hindsight bias, which tends to occur in situations where a person believes (after the fact) that the onset of some past event was predictable and completely obvious, whereas in fact the event could not have been reasonably predicted.

Many events seem obvious in hindsight. Psychologists attribute hindsight bias to our innate need to find order in the world by creating explanations that allow us to believe that events are predictable. While this sense of curiosity is useful in many cases (take science, for example), finding erroneous links between the cause and effect of an event may result in incorrect oversimplifications.

For example, many people now claim that signs of the technology bubble of the late 1990s and early 2000s (or any bubble from history, such as the tulip bubble of the 1630s or the South Sea bubble of 1711) were very obvious. This is a clear example of hindsight bias: if the formation of a bubble had been obvious at the time, it probably wouldn't have escalated and eventually burst.

For investors and other participants in the financial world, hindsight bias is a cause of one of the most potentially dangerous mindsets that an investor can have: overconfidence. In this case, overconfidence refers to investors' unfounded belief that they possess superior stock-picking abilities.

Avoiding Confirmation Bias

Confirmation bias represents a tendency for us to focus on information that confirms some pre-existing thought. Part of the problem with confirmation bias is that being aware of it isn't good enough to prevent you from doing it. One solution to overcoming this bias would be finding someone to act as a "dissenting voice of reason." That way you'll be confronted with a contrary viewpoint to examine.

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