Cognitive Biases Series:

Hindsight Bias

BY MEIR STATMAN, Ph.D.
Editor's note: This article is the fourth in a series.

Don’t gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don’t go up, don’t buy it. —Will Rogers

A physician came to ask for my advice in December 1994. He had worked hard and saved his money for many years and now, in his late forties, he no longer could continue at such a fast pace. All of his savings, $1.5 million, were in Treasury bills, and he was considering shifting some to stocks. But he was apprehensive. “The stock market is so high,” he said. “It’s bound to crash.”

I told the physician that I had not the slightest idea where the stock market was going over the next three, five, or even 10 years. But I relied on good evidence when I told him that stocks were likely to do better than Treasury bills over the long run. And a man in his late forties still has a long run.

I was feeling very smart in 1995 and kept feeling so through 1999, as if I could have seen with perfect foresight in December 1994 that the fabulous exuberance of the stock market was about to begin. But I kept reminding myself that I, like you and the rest of us, am subject to the mental trap that cognitive psychologists call “hindsight bias.”

Baruch Fischhoff, a cognitive psychologist, described hindsight bias as the belief that whatever happened was bound to happen, as if uncertainty and chance were banished from the world. So, if an introverted man marries a shy woman, it must be because (as we have known all along) “birds of a feather flock together,” and if he marries an outgoing woman, it must be because (as we have known all along) “opposites attract.”

Similarly, if stock prices decline after a prolonged rise, it must be (as we have known all along) that “trees don’t grow to the sky,” and if stock prices continue to rise, it must be (as we equally have known all along) that “the trend is your friend.”

We can see hindsight bias in action when we observe the attitudes of investors, both individual and institutional, toward international investments and currencies. In the late 1970s investors nodded their heads when consultants explained the benefits of global diversification, but they bought international stocks as sure future winners, knowing in hindsight that they were past winners. As Middleton wrote in the New York Times in 2003, “Foreign investing became fashionable when U.S. markets were relatively weak, beginning in the late 1970s. Between 1976 and 1989, the European, Australian, Far East Index surged more than sixfold, while the S&P 500 did not even quadruple.” But international stocks went out of fashion in the 1990s as investors learned, in hindsight, that their returns lagged those of U.S. stocks. “The sagging interest in Asian and European funds has sounded alarm bells among many financial experts whose mantra is diversification,” Tam wrote in the Wall Street Journal in 1998. The alarm bells of the 1990s quieted in the 2000s as international stocks beat U.S. stocks once again, but the alarm bells we should hear are the bells of hindsight. We continue to believe that we have seen in foresight what we have seen only in hindsight.

Hindsight bias also rules decisions to hedge currencies or not to hedge them. Comparing hedged and unhedged global portfolios during 1988–2003, I found that they had approximately equal returns and equal risk. Yet investors, driven by hindsight, continue to jump from bets on hedged portfolios to bets on unhedged portfolios, forever believing that their foresight is as good as their hindsight.

In March 2005, Cohn and Reed wrote in Business Week about Jim O’Neill, the “rock star” head of global economic research at Goldman Sachs: “O’Neill has won respect for prescient calls such as the one that accurately forecast that the euro would rise from $1.25 in February 2004, to $1.30 a year later…. he continues to see weakness in the dollar to the tune of 8% decline against the euro over the next 12 months. That would put the dollar at $1.40 to the euro by February, 2006.” Was the dollar at $1.40 to the euro by February 2006? I didn’t know in foresight, but we all know in hindsight.

Clients affected by hindsight infuriate consultants. “Why did you advise me to diversify globally?” they asked in the late 1990s after international stocks trailed U.S. stocks. “Why didn’t you advise me to hedge the currency exposure of my international stocks?” they ask after watching the appreciation of the dollar against the euro and the...
Hindsight Continued

In 2005, one tool for educating clients about the universal reach of hindsight bias is stories about our own susceptibility to the bias, as I just did in my story about the physician. A consultant shared with me another tool. At the first meeting of each year she presents clients with a long list of questions and asks them to make forecasts.

- Will U.S. stocks do better than international stocks this year?
- What will happen with the bond market?
- Will Donald Trump get divorced?
- Will Martha Stewart get married?

At the end of the year clients might be tempted by hindsight to remember the forecasts that came true. She takes the list out of the folder and reviews all the forecasts. She and her clients talk about hindsight bias and share a chuckle rather than a grudge. And she reminds her clients about the benefits of diversification. Those who truly have perfect foresight should invest only in the asset that would do best next year, international stocks, U.S. stocks, bonds, or hedge funds. But those, like us, who only are fooled by hindsight bias into thinking that our foresight is perfect should diversify among all assets.

We all make choices in an uncertain world and know, in hindsight, that some turn out to be horrendous mistakes. We cannot avoid choices and we cannot banish uncertainty. But we can learn to make wise choices and we can learn, grudgingly, to live with the consequences.

Meir Statman is the Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University. “This series draws on my work with investment consultants and investors at Loring Wadad Advisor Services,” he says. “They continue to teach me as much as I teach them.” Dr. Statman earned B.A. and M.B.A. degrees from the Hebrew University of Jerusalem and a Ph.D. from Columbia University. Contact him at mstatman@scu.edu.

References
Cohn, Laura and Stanley Reed. 2005. “Meet Goldman’s Rock Star,” available on the World Wide Web at http://www.businessweek.com/magazine/content/05_10/b3923171_mz035.htm (March 7.)