This is an original article written by Philip Loh; the edited version appeared in the Business Times Weekend 6-7 March 2010.

"Confirmation bias" can be costly for investors

Last March was an opportune time to enter the market, but many failed to do so. On hindsight, most investors now realise that they had a "once-in-a-generation" buying opportunity then.

Supposedly-savvy investors, when asked why they did not invest more last March or were holding a disproportional amount of cash then, will most probably say they did recognise the opportunity, but did not invest more due to personal reasons that have nothing to do with their market acumen. They may even cite feeble excuses such as that the significant other was holding them back, etc.

The truth is we are always seeking out information that fits our perspective of things. If I start out with the hypothesis that "buy-and-hold" is the best investment strategy, I will strive to find evidence to support this notion, while at the same time ignoring the evidence against it. This is called "confirmation bias". Consequently, when faced with a choice between changing my mind and proving there is no need to do so, I will probably find myself doing the latter instead.

To illustrate how self-confirmation bias can lead to costly investment errors, let us assume that I wake up one morning thinking that I should buy commodities-related investments on the basis that since commodities are finite resources, their value will rise due to scarcity, and they are therefore worth investing in.

To reassure myself that I have made the right choice, I google the topic and find search results that support my view. These information sources may have predicted that the price of crude oil will go up to US$200 per barrel, while that of gold will head towards US$3,000 per ounce.

To further boost my confidence, I start calculating to see how much I can make if these predictions came true; the more I read about it, the more it makes perfect sense to me. So the next day, I call my broker up to instruct him to buy up all the commodity-themed stocks listed on the exchange and invest with leverage in some commodity futures as well.

In actual fact, the factors affecting commodity prices are much more complicated. Short-term commodity prices are linked more to market sentiment than actual demand and supply. And what bears repeating is the fact that the market is always in equilibrium with an equal number of buyers and sellers.

The key question we should ask ourselves therefore is that if something is worth buying, who are the people doing the selling and what are they really thinking? Are they wrong in their reasoning? It may be at this point that we will realise that we do not know what the sellers are thinking in the first place.

In fact, in this age of Google, anyone with time to spare can find sufficient information on the Internet to support any viewpoint, including absurd notions like that Adolf Hitler and Joseph Stalin were admirable heroes. So whenever I find myself compelled to make an important

investment based on what seems like overwhelmingly strong evidence, I first calculate the maximum financial loss I will incur if my assessment is wrong. This risk management exercise will at least help me to pare my bet to an acceptable amount that I can stomach.

Another interesting belief that investors tend to blindly affirm without any sound proof nowadays is the notion that investing in emerging countries like China and India will reward them with better dividends than doing so in more developed economies. This is despite many academic studies showing that there is no positive correlation between GDP growth and stock market returns. If anything, the correlation is slightly negative.

The truth of the matter is that we should not buy shares based on statistical constructs like GDP. In fact, when we buy shares of immature companies in emerging economies, there is a high chance that many of these companies may actually end up becoming victims of the pursuit of profit.

Let us take the case of Japan for example. In the 1950s, when there were more than 100 motorcycle companies there, Tohatsu was the market leader then. But it was eventually driven out of business by an up-and-coming company called Honda. So while there is no doubt that China will continue to prosper in the coming years, can we be sure that those Chinese companies listed on the Singapore stock exchange are going to be the eventual winners in a cut-throat market like mainland China?

It is therefore important to note that the inability to differentiate between causation and correlation can lead us to wrongly conclude that we are in control when we are not. To prevent ourselves from making such a fallacious inference, we must first be aware of the brain's tendency to find patterns and react accordingly.

More importantly, we should be careful to avoid taking the wrong inferential leap to conclude that we are in control when our move proves to be correct, when there may in fact be no connection between our reasoning and our bet being proven right.

So the next time you are faced with seemingly convincing reasons to make an investment decision, it will be prudent to come up with some reasons why you should not take the plunge (or at least consider the possibility of deferring the decision to a later time). This may just save you from making a costly mistake for which you will greatly regret.