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## GETTING GOING

By JONATHAN CLEMENTS



# We Hear Just What We Want to Hear



Just tell me I'm right.

As investors, we face a heap of uncertainty, including inflation-rate fluctuations, gyrating markets and tax-code changes. To make matters worse, we could be forced to sell our investments at short notice because, say, we lose our job or we get hit with hefty unexpected expenses.

It's unpleasant to live with all this. So what do we do? We hunt for reassurance, especially in turbulent stock-market years like 2007. But this hunt can lead us astray.

### Suppressing Evidence

At issue is a behavioral phenomenon known as confirmation bias. We like to think of ourselves as rational observers of the world, weighing the facts and reaching well-reasoned conclusions.

But in truth, we all have our beliefs -- and we latch onto nuggets of information that support them, while shrugging off dissenting views and conflicting evidence. "Confirmation bias is so pervasive that it affects people without them realizing it," says Meir Statman, a finance professor at Santa Clara University in California.

That brings me to a recent example from my own finances. As I look around the global markets, I can't find much to get excited about. But Japanese stocks are an exception. Tokyo's 13-year bear market hit bottom in April 2003 and the Nikkei 225 Stock Average has rebounded handsomely since then. Still, I think the recovery has a ways to go.

All of which meant I was initially pleased when I recently read a financial newsletter that was advocating Japanese stocks. And then I caught myself. The reason: I had long thought the newsletter's editor was an idiot -- and yet, here I was, taking solace in his opinion.

### Most Agreeable

Think you're immune to confirmation bias? If you are a regular reader of this column, ask yourself this question: Why do you keep reading my articles?

Sure, I like to think I offer brilliant financial insights served up in peerless prose. But the reality is, I am not Warren Buffett -- and I am not Charles Dickens, either. I peddle a limited array of prosaic ideas. Worse still, I revisit these ideas all too frequently.

So why do you keep reading? It's no great mystery. You don't read my columns because they open your eyes to the financial world. Instead, you read them because they confirm what you already believe.

There is nothing wrong with this -- provided you and I have truth on our side. But what if we don't?

It's hard to imagine there can be anything wrong with saving diligently, keeping investment costs low and betting on stocks for the long haul. But maybe we're making some fundamental assumption that will prove badly flawed.

One possibility: Suppose history turns out to be a rotten guide to the future -- and stock returns fall far short of our expectations. This isn't wildly improbable.

We may take comfort from the U.S. stock market's long history of impressive returns. But, as financial historians are quick to note, this is history as told by the winners. Other national stock markets didn't fare nearly so well over the past century, and some were shuttered for long periods by war and political turmoil.

Even without some sort of calamity, there is good reason to think U.S. stocks won't rival their historical performance. In early 1957, stocks were trading at 13 times earnings and yielded 4%. In early 2007, they are at 17 times earnings and yield less than 2%. Because stocks are more richly valued today than they were 50 years ago, returns are likely to fall short of their 10%-plus historical average.

### **Betting Big**

I am not arguing that you should dump your stocks. Rather, I believe we need to accept that there is great uncertainty and that our best defense is to avoid big investment bets, instead spreading our dollars across a broad array of stock and bond-market sectors.

It is those big bets that can do serious damage to our finances -- and where confirmation bias can be most dangerous. Suppose you decide rough times lie ahead for the stock market and you sell all your stocks and stock funds.

And then you make an even bigger mistake, which is to tell your brother-in-law. Now, not only is your money on the line, but so too is your ego -- and there is no backing down.

"You've invested yourself, not just your money," Prof. Statman says. "Confirmation bias becomes more and more severe the more invested you are in the idea."

### **Pleading Ignorance**

On the other hand, investing a little of your ego isn't such a bad idea. If you're going to stick with your portfolio at times of market turmoil, you need unflinching commitment. My advice: Develop a sense of conviction -- about your profound ignorance.

I have been covering personal finance for two decades and I am continually amazed by how little I know. I can't, with any certainty, tell you where share prices or interest rates are headed over the next year or even the next five years. Similarly, I have no idea which highflying stocks and which star mutual-fund managers will continue to shine.

And I don't think others can do any better. Predicting markets is all but impossible, in part because extraordinary things happen with alarming frequency. Think about the past 20 years.

We had the Dow Jones Industrial Average plummet 22.6% on a single day in 1987. Communism collapsed. The U.S. went to war with Saddam Hussein not once, but twice. We held a presidential election, and one man won the popular vote and the other won the Electoral College. Terrorists destroyed the World Trade Center. Standard & Poor's 500-stock index gained over 20% in five consecutive years in the late 1990s -- and then suffered three years of devastating losses.

Faced with this sort of uncertainty and our own ignorance, it makes sense to focus on controlling those things that we truly can control. Hold down investment costs. Diversify to reduce investment risk. Minimize taxes. Save aggressively.

This may not sound terribly exciting. But it should be reasonably profitable. An added bonus: If we build our investment strategy around the notion that we're pretty darn ignorant, we probably won't have to wait very long for confirmation.