

## Investing Insights from Doctors

By Dan Richards\*

April 27, 2010

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I work out in the early mornings with a psychiatrist. He recently forwarded an [article](#) in the *New York Review of Books* by Jerome Groopman, a physician and frequent writer on the challenges of modern day medicine. As I read it, I was struck by the parallels between the things that cause doctors and investors to go wrong.

Dr. Groopman began by writing that “10% to 15% of patients suffer from a delay in the correct diagnosis or die before the correct diagnosis is made.”

Technical problems almost never cause this. Rather, human nature and the difficulty in making good decisions under pressure get in our way – “clear thinking cannot be done in haste,” Dr. Groopman writes.

In his article, he points to pioneering work by psychologists Amos Tversky and Daniel Kahneman in identifying three biases that cause people to make poor decisions. In 2002 Professor Kahneman received a Nobel Prize in economics for this work, the only non-economist to date to receive this honor.

### **The perils of anchoring**

The first factor that causes doctors and investors to go wrong is “anchoring” – the tendency to focus on one factor and ignore other evidence.

Tversky and Kahneman said that people intuitively associate higher income and sunshine with happiness. As a result, they dramatically overestimate the impact of an increase in income or living in warmer climates on happiness, even though no evidence supports those beliefs.



Another example might be someone buying a used car who fixates on the mileage while ignoring the overall condition of the engine.

Doctors can anchor on the first symptom that presents itself, ignoring other problems.

And investors can focus only on a company's share price, only buying when it has dropped from previous levels – neglecting to consider whether there have been changes in the firm's circumstances.

### **The availability effect in action**

A second aspect of human nature that causes poor decisions is the tendency to extrapolate from high profile or recent events and rely too heavily on easily accessible and “available” data.

For example, when there's a plane crash, extensive media coverage makes some people reluctant to fly – while quite happily embarking on long distance car trips. Meanwhile, the chances of dying in a car accident are dramatically higher than when flying a similar distance.

An associated problem is the “recency effect,” in which we give more recent information higher weight. For doctors, recent dramatic cases color their judgment and cause misdiagnosis. And for investors, this leads to the tendency to chase the stocks or sectors that have done well in the past while – just think back to the tech bubble, when investors were swept up by the frequent reports of yet another dot com IPO tripling in the first day of trading.

### **The cost of attribution**

The third bias that causes people to go wrong is the attribution effect, drawing conclusions from stereotypes rather than data.

A doctor may see someone who is obese or a heavy smoker or drinker and immediately leap to conclusions about the causes of their ailment.

Similarly, investors regularly fall victim to stereotypes. They often dismiss slow growing “old economy” companies and industries in favor of those with prospects for better growth. Or they dismiss European companies as old, tired and hidebound, unable to compete in today's world.

Research by Jeremy Siegel of Wharton has illuminates the fallacy of this logic. Since the mid 1950s, the stock price of the fastest growing companies actually underperformed the market as a whole. And over the past 40 years, the



performance of European stocks has significantly outperformed the American stock markets.

### **Learning from mistakes**

After identifying the causes of misdiagnosis, Groopman went on to write “the most instructive moments are when you are proven wrong and realize that you believed you more knew more than you did.”

One of the most costly traits of human nature is overconfidence. That’s true of military and political leaders, it’s true of CEO’s – and it’s true of doctors and investors.

One of the hallmarks of both military commanders and top investors is humility – constantly being aware that they may be wrong. As a result, they’re always open to new evidence that contradicts preconceptions and existing views.

These days, many investors and the financial advisors they work with are reflecting on the events of the past couple of years and reshaping their strategies going forward. As part of that process, it’s important to think about strategies to avoid the traps of human nature that cause both doctors and investors to go wrong. Only by doing that will investors maximize their portfolio returns going forward.

*\* Dan Richards conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries and to reach him, go to [www.clientinsights.ca](http://www.clientinsights.ca).*

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