Behavioural Finance: Rules of Thumb and Representativeness

- The discipline of investing has many “rules of thumb” that often lead investors astray.
- Representativeness can be defined as, “What are the odds that A belongs to category B?”
- By assuming all investment opportunities are new and unique we can avoid the representativeness heuristic.

In Behavioural Finance: An Introduction to Human Error, we noted that Kahneman and Tversky were smart academics who found many ideas for their social science experiments in the mistakes that they themselves made as well as the mistakes that their intelligent colleagues and subjects made. Kahneman and Tversky (K&T) noted some rules of thumb that often lead investors astray. If you can get past the academic naming conventions, the concept is both interesting and insightful.

Heuristics

A heuristic is a “rule-of-thumb,” or a shortcut. In Kahneman’s latest book, Thinking, Fast and Slow, he attributes much of the use of short cuts to the part of our thinking process that is automatic, quick, and effortless. He refers to this as “System 1.” On the other hand, he notes “System 2 allocates attention to the effortful mental activities that demand it, including complex computations.” Our brain’s resource allocation between System 1 and System 2 is usually efficient, but efficiency comes with the cost of error.

For example, System 1 and rules of thumb can be lifesavers. Knowing that many snakes are poisonous leads us to automatically avoid slithering animals before we put System 2 to work to determine the animal’s true nature. If, instead of recoiling, our ancestors studied every snake, they would not have survived long enough to become our ancestors. The efficient allocation of resources between Systems 1 and 2 allows us to expend mental energy when necessary, and preserve it when not. But, in complex social and investing environments, System 1 and rules of thumb can cause problems.

“System 1 has biases...systematic errors that it is prone to make in specified circumstances...it sometimes answers easier questions that the one it was asked, and it has little understanding of logic and statistics.” Perhaps most troubling is that System 1 is always working even when we are not aware that it is, giving us quick and easy answers that may not be accurate. It makes it more difficult to put System 2 to work when we should. “Biases cannot always be avoided, because System 2 may have no clue to the error.” The best defence may be the awareness that System 1 is automatic, and “learn to recognise situations in which mistakes are likely and try harder to avoid significant mistakes when the stakes are high...it is easier to recognise other people’s mistakes than our own.”

Representativeness

The question that K&T first posed to describe the representativeness heuristic is “What are the odds that A belongs to category B?” Often we know little about A but we make quick judgments about it anyway. If A has characteristics that seem to be similar to the characteristics of things in category B, we estimate that A belongs to category B.

K&T felt that the representativeness heuristic is activated largely because we ignore or have little knowledge of probabilities; we are not sufficiently sensitive to sample sizes; we misconceive pure chance as meaningful; and have a poor sense of the way regression-toward-the-mean unfolds. For example, insensitivity to base rate frequencies caused many survey subjects to conclude that a stranger who is described as shy was more likely to be a librarian than a bank teller even though there are many more bank tellers than librarians.
The following paragraph contains references to publicly traded companies. We selected these companies to illustrate the behavioural finance characteristics discussed in this paper and because they’re familiar to many investors. These references are for ILLUSTRATIVE PURPOSES ONLY. The references are NOT RECOMMENDATIONS to transact in any securities issued by these companies.

For a hypothetical investing example of representativeness, we could pose the question, “What are the odds that Samsung’s stock will perform the way Apple’s stock performed?” Many in the U.S. know little about Samsung, a South Korean company, compared with what they know about Apple. Yet, they know that Samsung makes a good smartphone, tablet, and computer that are as fun to use as Apple’s products. But, these two complex businesses are not similar enough to draw investment conclusions merely because of the similarities of a few of their products. They largely serve different geographic markets; they largely make different products; they have dissimilar financing capabilities, government support, and market prices relative to their accounting fundamentals; they use different accounting methods; and they even report their results in different currencies. Good luck drawing investment conclusions by comparing smart phones.

If we assume that every new investment opportunity that comes across our desk is vastly different from everything that we have seen before, we will not give representativeness a chance to work. If we vow that we will never put money into an idea until we have spent days with it, forced ourselves to find something bad about it, and crunched the numbers—forcing ourselves to use System 2 for every investment idea—we may miss some good opportunities, but it hopefully will prevent us from investing in even more bad ideas.

The next paper in our series, entitled: “Behavioural Finance: The Three A’s – Availability, Adjustment and Anchoring”, examines the remaining early behavioural investment biases.

Glossary of Financial Terms

- Fundamentals: Fundamentals refers to data that can be used to assess a country or company's financial health such as amount of debt, level of profitability, cash-flow, inventory size etc.
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