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THE INTELLIGENT INVESTOR

The Panic of 2020? Oh, I Made a Ton of Money—and So Did You

Hindsight bias suggests that one day you'll look back on all of this and... lie

ILLUSTRATION: ALEX NABAUM

By

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It's springtime in the year 2030. You're looking back at the crash of 2020, the devastation it dealt your portfolio and how you behaved as an investor.

What will you say?

If human nature is any guide—and, let's face it, it is—your accounts of what happened will begin with such words and phrases as "Clearly..." or "It was obvious to me that..." or "Everybody knew that..."

In the future, your memory of the crash of 2020 won't be a recollection. It will be a reconstruction, built partly from what is happening now and largely from what you learn later about what hasn't happened yet.

I'm describing hindsight bias—the belief, after something happens, that we foresaw that it would occur.

That intuition keeps you from learning from mistakes, leads you to pay too much attention to unreliable forecasts and makes you mismeasure your tolerance for risk.

SHARE YOUR THOUGHTS

Do you look back at your past investment decisions? If so, what lessons have you learned from that practice? Join the conversation below.

Fortunately, you can work around it.

Some commentators have argued that the coronavirus panic is nothing like the financial crisis of 2008 and 2009 because, unlike today, policy makers knew exactly what they were doing back then. That's nonsense. Monetary and political leaders navigated that time not with foresight but with a jury-rigged blend of bluffing, analysis, tinkering, bickering, guesswork and luck.

Don't let yourself be fooled into believing it's unusual that nobody knows what's going on right now. The past makes sense only in retrospect, after our minds burnish it to our liking. The present almost always defies our efforts to make sense of it.

In a classic experiment in 1972, researchers asked people to estimate the likelihood that various positive and negative outcomes might result from President Richard Nixon's upcoming trips to China and Russia that year. We now call those visits "historic" because they thawed decades of hostility between the U.S. and the communist powers. In advance, no one knew whether the trips would accomplish anything.

About two weeks after Nixon's visits, 71% of people recalled putting better odds on his success than they had at the time. Four months on, 81% remembered being more sure Nixon would succeed than they had said beforehand.

In short, learning what *did* happen impedes you from retrieving what you thought *would* happen.

Children as young as the age of three, asked what's in a candy box, will say "candy." Show them it contains pencils instead, then ask what they had thought would be inside—they will say "pencils."

One week after the verdict in the 1995 murder trial of O.J. Simpson, 58% of people in a study recalled predicting he would be found not guilty; a year afterward, 68% remembered saying he would be acquitted. In fact, only 48% of them had said so before the verdict. Likewise, people distorted the odds they'd placed in advance that President Bill Clinton would be convicted in his 1999 impeachment trial.

In 2002, psychologists asked nearly 1,000 Americans to recall how likely they had expected terrorism-related incidents—and other risky events—to be in the immediate aftermath of Sept. 11, 2001. After a year in which fears had mostly subsided, they remembered being much less pessimistic than they had been at the time.

So that pundit predicting doom on financial television right now will get to say "I told you so" if the economy collapses. But if things improve, he—and his audience—will end up remembering his forecast as sunnier than it was.

"We're biased to see ourselves in a positive light," says Deborah Small, a psychologist at the Wharton School at the University of Pennsylvania. "We want to believe that we're rational and smart. We'll recall our past actions as more sensible than they were. We also give ourselves too much credit and don't remember our mistakes as well as we do our successes."

Sure enough, investors looking back on their own decisions often recall more gains and fewer losses than they racked up in reality.

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To combat hindsight bias, tune out economic and financial forecasters who don't share complete track records of their predictions. (If that leaves you with no one to listen to, well, them's the breaks.)

Next, track your own forecasts. If, as I have often urged, you kept an investment diary during the financial crisis, go back and read it. How accurately did you predict how far stocks would drop and how long they would take to recover? If you were wrong about the past, how likely are you to be right about the present and the future?

Finally, take what psychologist Daniel Kahneman calls “the outside view.” Rather than try to figure out exactly how bad this crisis will be, look at the broader set of historical precedents.

Since 1929, the S&P 500 has suffered 14 bear markets, defined by S&P Dow Jones Indices as losses of at least 20%. The shortest and shallowest was the 20% drop that lasted less than three months in late 1990. The deepest was the 86.2% collapse from September 1929 to June 1932; the longest, the 60% plunge from March 1937 to April 1942. On average, bear markets lasted 19 months and dealt a 39% loss.

Staring the past honestly in the face, rather than letting your memory play tricks on you, is the best way to form realistic expectations of the future.

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