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Good Hindsight Shortcuts Can Help Avoid Costly Hindsight Errors

ACADEMIC PERSPECTIVE

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Admonitions against hindsight errors are common and conveyed in sayings such as “Hindsight is 20/20” and “Monday morning quarterbacking.” Or, “Nothing is so easy as to be wise after the event,” which an English appellate court noted in an 1859 decision involving a railway company’s potential liability for a platform injury (*Cornman v. The Eastern Counties Railway*). Financial advisers serve their clients well when they guide them to use good hindsight shortcuts and avoid costly hindsight errors.

HINDSIGHT SHORTCUTS AND ERRORS

Good hindsight shortcuts lead us to repeat actions that brought good outcomes and avoid actions that brought bad ones. We did favors for friends and they subsequently returned them. We learned that reciprocated favors are the likely outcomes of doing favors.

Hindsight shortcuts are always precise when there are one-to-one associations between past events and future events, actions and outcomes, and causes and consequences. But hindsight shortcuts can easily turn into hindsight errors where randomness and luck are prominent, loosening associations between past and future events, actions and outcomes, and causes and consequences.

Fast driving when luck is good gets us to our destination sooner, but fast driving when luck is bad gets us a speeding ticket or worse. Hindsight errors can mislead lucky drivers into thinking that fast driving always gets them to their destinations more quickly and mislead unlucky drivers into thinking that fast driving always gets them a speeding ticket. Hindsight errors also mislead lucky traders into thinking that fast trading always gets them to their profit destinations more quickly and mislead unlucky traders into thinking that fast trading always inflicts losses.

Hindsight errors are a serious problem for all historians, including stock market historians. Once an event is part of history, there is a tendency to see the sequence that led to it as inevitable. In hindsight, poor choices with happy endings are described as brilliant choices while unhappy endings of well-considered choices are attributed to horrendous choices.

Psychologist Baruch Fischhoff who introduced us to hindsight shortcuts and errors wrote, "In hindsight, people consistently exaggerate what could have been anticipated in foresight. … People believe that others should have been able to anticipate events much better than was actually the case. They even misremember their own predictions so as to exaggerate in hindsight what they knew in foresight."[1]

HINDSIGHT ERRORS IN INVESTOR BEHAVIOR

"Who's better for stocks: Dems or GOP?" asked a CNBC article on Nov. 7, 2016, the day before voters elected Donald Trump as president. "As the historic 2016 U.S. presidential election approaches," it said, "major Wall Street analysts agree that the S&P 500 will likely sell off if Donald Trump wins, and at least hold gains if Hillary Clinton wins."

"We believe that if Trump wins, markets are likely to fall further," said stock market strategists of one investment company. "The S&P 500 could potentially fall 11 to 13 percent if Trump wins the election," said the strategists of another investment company. And the strategists of a third investment company said, "A Trump win would likely result in jittery markets, while markets would likely be happy with a Clinton victory."[2] These forecasts and their refutation, only a day later, teach us that hindsight is much clearer than foresight.

Investor Warren Buffett understands well the distinction between hindsight and foresight and the temptation of hindsight. In his biography of Buffett, author Roger Lowenstein describes events surrounding the increase in the Dow Jones Industrial Average beyond 1,000 in intraday trading in early 1966 and its subsequent decline by spring. Some of Buffett's partners phoned to warn him that the market might decline further. Buffett said such calls raised two questions:

1. If they knew in February that the Dow was going to 865 in May, why didn't they let me in on it then?
2. If they didn't know what was going to happen during the ensuing three months back in February, how did they know in May?[3]

CORRECTING HINDSIGHT ERRORS

We cannot immunize ourselves against hindsight errors, but we can be aware of them and correct them in ourselves and our clients. An adviser shared with me a method she uses to correct clients' hindsight errors. At the first meeting of each year, she presents clients with a list of questions about the coming year and asks them to make forecasts. The questions are along these lines:

> Will Nicolás Maduro cease to be president of Venezuela?
>
> Will Mark Zuckerberg step down as Facebook's sole chair or CEO?
>
> Will domestic U.S. stock funds outperform international stock funds?
>
> Will value stocks outperform growth stocks?
>
> Will a magnitude 7.0 or higher earthquake strike California?
>
> Will Donald Trump get divorced?
>
> Will Martha Stewart get married?

At the end-of-the-year meeting, hindsight might tempt clients to remember forecasts that came true. Why did you invest any of my money in international stocks when it was clear in foresight that they will lag U.S. stocks? Why did you invest any of my money in value stocks when it was clear in foresight that they will lag growth stocks? Now the adviser takes out the list and educates her clients about the pitfalls of hindsight errors. Perhaps we would all be wise to make and keep such a list to remind ourselves of this potential bias.

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Endnotes

[1] Fischhoff, Baruch. 1982. "Debiasing." In *Judgment Under Uncertainty: Shortcuts and Biases*, edited by Daniel Kahneman, Paul Slovic, and Amos Tversky, 422-444. Cambridge: Cambridge University Press.

[2] Cheng, Evelyn. 2016. "Wall Street reacts: Here's what the markets will do after the election." CNBC, Nov. 7, 2016. http://www.cnbc.com/2016/11/07/market-predictions-sp-500-to-sell-off-if-donald-trump-tops-clinton-and-more-from-wall-street.html

[3] Lowenstein, Roger. 1995. *Buffett: The Making of an American Capitalist*, 97. New York: Random House.

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