BEHAVIORAL FINANCE 101 -HINDSIGHT

April of 2000, Krispy Kreme had a very successful Initial Public Offering. From the IPO price of $21 a share, it opened for trading at $32 a share and subsequently zoomed up to $37 a share. I spoke with someone later who said they "just knew" that would happen and regretted not buying the stock. Of course, no one actually "knew" what would happen to the stock when it began trading. There were a number of potential outcomes, but we all find past events to be more predictable than they were prior to the outcome.

We have all heard the expression that "hindsight is 20/20," meaning that we see perfectly when we know the final outcome and look backwards. Unfortunately, life is lived forward, not backward, and things that seem so clear when looking backward appear rather murky when looking forward.

Whether it is a sporting event, a political election, an investment or a person's life – events that actually*did* occur seem more evident, in hindsight, than the myriad events that *could have* occurred, but did not. Because of hindsight bias, we beat ourselves up – or blame others – for not having foreseen the "inevitable" outcome that we now so clearly see, in hindsight.

As soon as the stock market closes each day, pundits begin explaining why it did what it did, and they sound so smart and incisive. We think, "of course, anyone could see that would have been the result today." But, if the day's market had resulted in a different outcome, those same pundits would be explaining the opposite result in the same perceptive tones.

What will happen over the next year with the economy and the markets as the Federal Reserve begins unwinding its easy-money policies?There are a number of possible outcomes and no one knows at this point how it will actually play out – and therefore portfolios must be constructed today with that uncertainty in mind.

What are the dangers and consequences of our natural tendency to exhibit hindsight bias?

We don't learn from past mistakes or critically examine our decision-making process after-the-fact.

- We consider poor decisions that had positive outcomes to be smart strategies.
- We consider brilliant and well-thought-out decisions that unfortunately had negative outcomes to be

mistakes.

- We overestimate the degree with which we could have predicted or anticipated an outcome.

A significant aspect of managing investments is the management of risk, and risk is very complex and multi-faceted. Often, when we discuss risk we are talking about managing a number of potential outcomes with known probabilities of occurrence. But, in the real world there is uncertainty, and the greatest risk may be the things that are left over after we think we have thought of everything. These are the “unknown unknowns.”

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