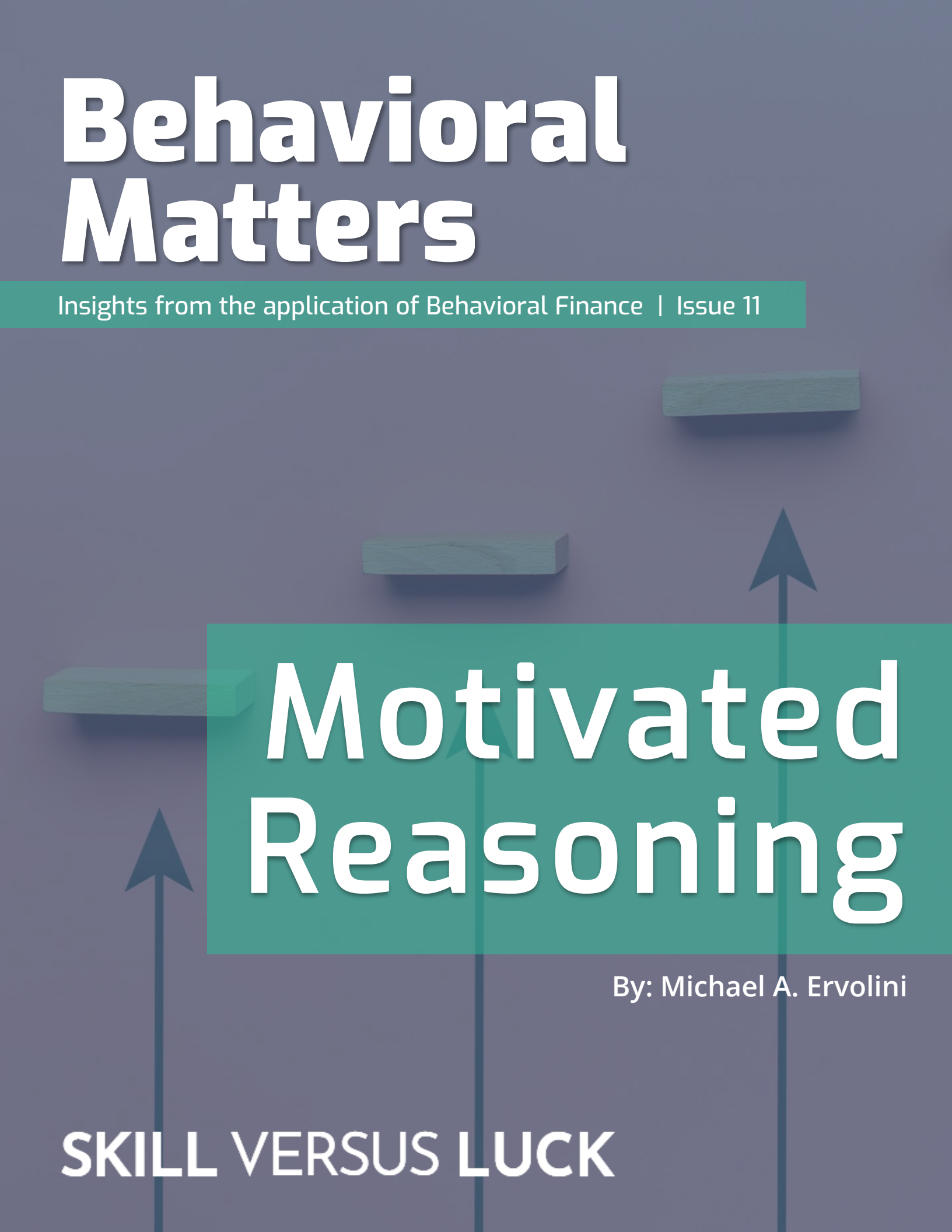


Behavioral Matters

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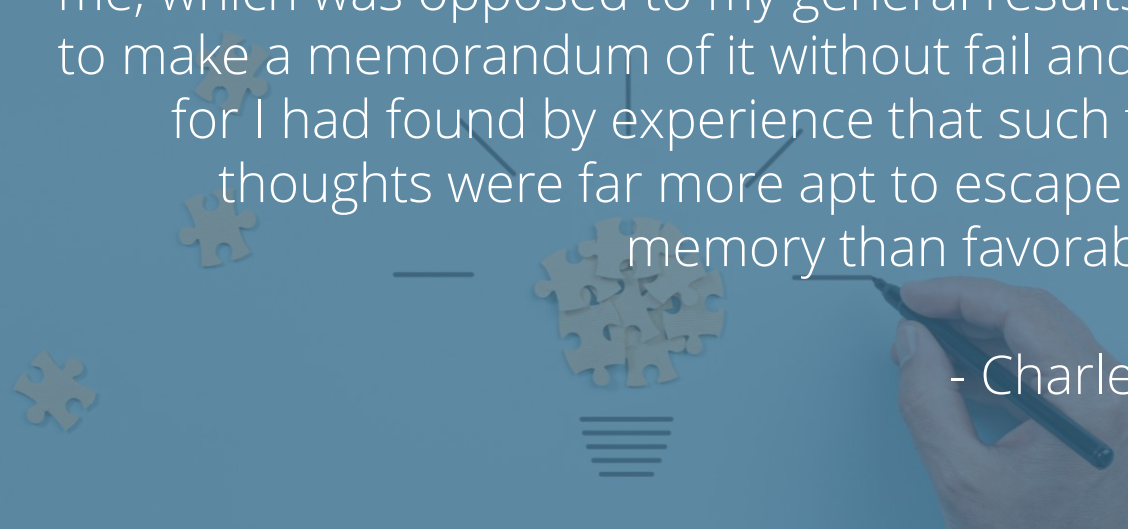
Motivated Reasoning

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SKILL VERSUS LUCK

INTRODUCTION

Behavioral Matters is a series of essays on the application of Behavioral Finance written specifically for professional investors and portfolio managers.



“Whenever a new observation or thought came across me, which was opposed to my general results, [I tried] to make a memorandum of it without fail and at once; for I had found by experience that such facts and thoughts were far more apt to escape from the memory than favorable ones.”

- Charles Darwin

Confronting our own mistakes in judgment is painful. It is one reason we rationalize. Rationalization can, however, alter our interpretation of facts and lead to ineffective decisions. Rationalization is one of the powerful unconscious forces that can drive you towards behavioral investing. In this essay we discuss rationalization, motivated reasoning and five simple ideas for greater self-awareness.

WISHFUL THINKING

Rationalization is something we all do. Call it wishful thinking. By either name, it's the tendency people have to fit perceptions of reality into a mold that is heavily influenced by preferences. Most of us are highly selective in the information we choose to process and how we process it, for emotional rather than analytic reasons.

When it comes to equity investing, wishful thinking can be devastating. It can blind us to undesirable facts without which we are likely to make ineffective decisions. Rationalizing causes us to depend on confirming information and minimize the significance of conflicting information. Since rationalizations come about comfortably and naturally, they often hide from our conscious ability to detect them, let alone manage them.

MOTIVATION MATTERS

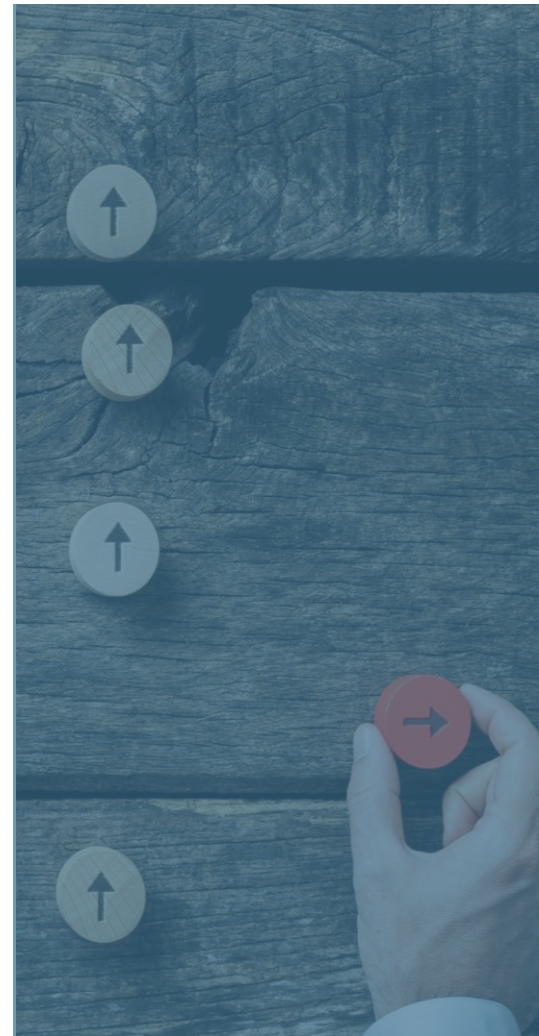
One model for understanding how and why we rationalize, called Motivated Reasoning, suggests that the brain works to satisfy two distinct functions simultaneously – analytic thinking and emotional thinking. While analytic thinking strives to achieve the best fit for the data at hand (accuracy), emotional thinking wants to reinforce existing beliefs and diminish conflicting data (directional). Those directional goals reflect our beliefs, biases and desires. Interplay between accuracy and directional goals can result in radically different reasoning given the same information at different times. Or as Professor Ziva Kunda puts it: "People rely on cognitive processes and representations to arrive at their desired conclusions, but motivation plays a role in determining which of these will be used on a given occasion."

NOBODY'S FOOL

Rationalization is often misconstrued as an intentional effort to fool ourselves. To the contrary, we are often very sincere in our assessment of our reasons, while rationalizing. Consider the commonly observed behavior from Prospect Theory involving "risk seeking with losses." A new position is down by 30% a short time after purchase. The manager decides to buy more believing that it is at a bargain price and sure to bounce. Objectively this may represent a shrewd capitalization on an over-beaten stock. On the other hand, it might be another case of taking even greater risks in the hope of ultimately breaking even.

The interaction between facts and unconscious desires is explained by Professor Kunda this way: "People do not seem to be at liberty to conclude whatever they want to conclude merely because they want to. They draw the desired conclusion only if they can muster up the evidence necessary to support it."

A contributing factor is that we have a strong need to explain why we make our decisions and actions to ourselves and to others. In explaining our reasoning, motivations for self-efficacy and respect, result in our formulating a narrative. The narrative lays out all the facts as a reasonable and compelling story. Our need to feel good about ourselves and be respected by others, however, fills in around the facts until the narrative morphs into more of a fable than an accounting of what transpired.



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RATIONALIZING BEHAVIOR

Rationalization underpins many well known behavioral tendencies: Self Attribution, Anchoring, Hindsight Bias, Optimism Bias and overconfidence, to name a few.

Motivated Reasoning can result in our need for a certain conclusion that then shapes how facts are interpreted. The need to explain can lead to narratives that deliver the wrong lessons to our memories. This, in turn, can result in heuristics, beliefs and biases that push us repeatedly and predictably towards ineffective decisions. Or as Artimus Ward once said: "It ain't so much the things you don't know that get you in trouble. It's the things you know that just ain't so."

CONCLUSION

Rationalization reflects an internal struggle between interpreting facts and wanting an outcome that coincides with a belief or desire. As a result, the brain converges on a solution that incorporates available information while minimizing negative and maximizing positive feelings.

Rationalization positions us to readily accept facts that support our desire or belief while urging us to hold unfamiliar or unpleasant facts to a higher standard. Unconscious filtering results in a narrative that passes both our conscious scrutiny and that of others whose respect is desired. Ironically, scrutinization of why decisions were made or actions taken actually gives the illusion of being objective. To make matters even more difficult, the more intelligent the person is the better they will be at constructing and presenting a believable narrative.



CONCLUSION



Tough-minded investment management requires strong doses of introspection. To help in implementing your heightened self-awareness here are five reminders to pin up on your office wall:

1. The brain tries to see relationships or stories, even when there are none.
2. The brain forgets and remembers what it wants, in a very biased way.
3. Narratives, even the most earnest of them, reflect Motivated Reasoning.
4. Actively search for data that was overlooked or that contradicts my theories or beliefs.
5. How would someone who disagrees with me look at this data?

ENDNOTES

1. *"The Case for Motivated Reasoning"*, *Psychological Bulletin*, the American Psychological Association, November 1990 Vol. 108, No. 3, by Ziva Kunda.
2. *Perspectives on Self-Deception*, by Brian P. McLaughlin and Amélie Oksenberg, University of California Press, 1988.
3. *How We Know What Isn't So: The Fallibility of Human Reason in Everyday Life*, by Thomas Gilovich, Simon & Schuster, 1993.
4. *Don't Believe Everything You Think: The 6 Basic Mistakes We Make in Thinking*, by Thomas E. Kida, Prometheus Books 2006.