All about Confirmation Bias and Hindsight Bias.

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Executive Summary: Confirmation Bias and Hindsight Bias are two significant concepts of behavioural finance which can often lead to taking incorrect financial decisions. Confirmation Bias refers to a tendency to look out only for information which supports your earlier beliefs or opinions about anything. Hindsight Bias refers to the belief that you could have predicted an event which happened in the past. Both these biases need to be avoided to make correct decisions. Understand all views of a subject before evaluating it and avoid overconfidence.

Imagine that you have a Systematic Investment Plan (SIP) amounting to Rs. 5000 worth of investment every month in a large cap diversified equity mutual fund. You plan to accumulate a corpus of Rs. 10 lakhs at the end of 10 years using this investment. One day at work you get into an investment discussion with your colleague who is also investing in a SIP of another large cap diversified equity mutual fund. Your colleague insists that his investment is better than yours and he points out to a few reasons as to why your choice of fund may not be the best one. However, you are biased to continue investing in this fund as your best friend has also done so. So you start looking for information to confirm your choice and go out of your way in trying to prove to your colleague. This is known as Confirmation Bias.

Meaning of Confirmation Bias: Confirmation Bias is essentially a tendency to pay attention to information which favours your beliefs and opinions, while ignoring any other information. In the above example, this means that instead of looking for reports or research which talks of why your choice of fund MAY NOT be the best bet, you search for information which says that your choice was correct. So you only tend to look at one kind of information, which supports or goes by what you thought was right in the first place.

Now let’s take another example. The 2008 financial crisis crippled financial markets and investments across the world. Suppose as an investor, you had always been wary of investing in the equity markets and directed 90% of your investments in bank fixed deposits. If after the financial crisis, you claimed that you knew that the event was going to happen and therefore you did not invest in equity markets, this is known as Hindsight Bias.

Meaning of Hindsight Bias: Hindsight Bias is the belief that one could have foreseen the happening of an event which happened in the past, as it was predictable and completely apparent for the event to have occurred. This is true even for non financial events like terrorist attacks or other situations like these. As these events look obvious in hindsight, this is known as Hindsight Bias.

Why are Confirmation Bias and Hindsight Bias not good? Both Confirmation Bias and Hindsight Bias tend to cause problems in financial matters as there is a skewed opinion while taking financial decisions. In the case of Confirmation Bias, the individual is only concerned to source information
which ‘confirms’ his preconceived beliefs and notions. He does not look at the contrarian view to a situation. This actually means that the individual is emotionally dealing with his investments and not taking an objective view while evaluating them. Also, there is no all rounded information while evaluating a decision and this can often result in taking an incorrect decision. In the case of Hindsight Bias, the individual tends to become overconfident, as he begins to believe that he can foresee future events. Overconfidence by itself is quite a dangerous behavioural finance trait which can often lead to taking incorrect financial decisions.

**How to avoid these biases?** Simply being aware of these biases will not help you overcome it. You will need to proactively work on avoiding them. For example, in the case of Confirmation Bias, when you believe that a financial product or decision is correct, search for information which can give negative feedback on the subject. Do not blindly go by third party opinions. Do your own research, understanding the pros and cons of every decision you make. Discuss your woes and opinions with your financial planner to understand a professional view. Play the ‘Devil’s Advocate’ when thinking of money matters.

*While the above post is original, concepts have been reviewed from [Investopedia.com](http://Investopedia.com) and other websites.*