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GOERNERT WEALTH MANAGEMENT

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The Dunning-Kruger effect and the implication for investors

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The following story is going to sound like an Urban Legend but it's true. According to local news reports, in 1995 McArthur Wheeler robbed two banks in Pittsburgh. The robberies were not notable, in a large city, bank robberies happen all the time. What was notable was the fact that the robber walked into each bank in broad daylight with no discernable disguise. The bank's security cameras were able to get clear pictures of the suspect which were then broadcast that night on the 11 O'clock news. Within an hour, police were able to identify and arrest Wheeler. When confronted by police with the bank surveillance footage, Wheeler was astounded "but I wore the juice" he said. It turns out that Wheeler had been convinced that since lemon juice is used to make invisible ink, if he rubbed it on his face, it would render his face invisible to the cameras. Now obviously, McArthur Wheeler is never going to be the president of the local Pittsburgh MENSA chapter, but Wheeler's misadventure was the genesis for a research project by Justin Kruger and David Dunning of Cornell University.

Dunning and Kruger were fascinated by this, albeit extreme example of what is known as cognitive bias. In this case, why would a man with so little knowledge and understanding of the properties of light and chemistry (cameras and lemon juice) so confidently trust his judgement and risk incarceration based on his faulty knowledge. It led them to postulate that this was not a random event and that this phenomenon, in less extreme permutations, is a key attribute to human psychology. They conducted further research and concluded in their 1999 Cornell study that, in fact, the less knowledge about a discipline a person has, the more competent they will consider themselves and will tend to drastically overestimate their abilities in that subject. Paradoxically, they also found that the more knowledgeable and accomplished a person is in their field of study, the more they tended to underestimate their expertise level. Now when you think of it, it might not be such a paradox. The more we study a subject, uncover its nuances, discover its depth and breadth, the more we recognize what we need to learn. In other words, the more we learn, the more we are aware of what we don't know.

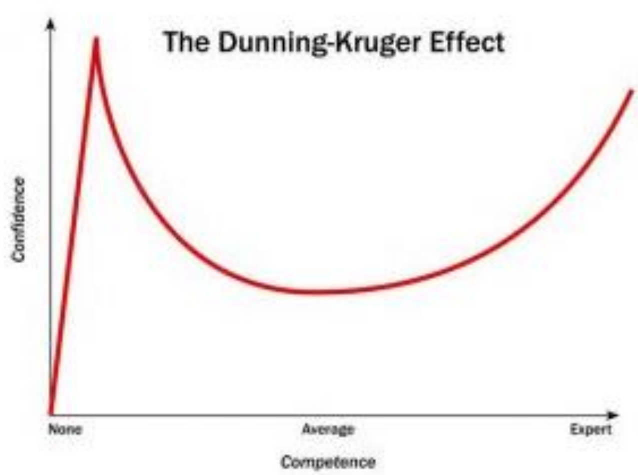
In a similar vein, in 1981 Ola Svenson found that 77% of Swedish college students and an astonishing 88% of American college students considered themselves above the 50th percentile line when asked to assess themselves with regards to their driving skill and risk behaviour versus the average driver. This is a mathematical impossibility. By definition, 50% of the study sample must be above the 50th percentile line and 50% below it. This is sometimes referred to as the "Better-Than-Average Effect". So, what does this mean for us as investors?

Forewarned is forearmed

Now I want to be clear here. The point of this piece is not to patronizingly pat you on the head, as many in my industry do, and say you should leave investing decisions to the experts or insinuate that you have no place in managing your hard-earned wealth. What I'm trying to convey is a lesson my father used to repeat to me in my youth. He was fond of saying, "forewarned is forearmed". The meaning of the proverb is that prior knowledge of possible dangers gives you a tactical advantage in any given situation. In this case, the danger I am highlighting is that cognitive biases exist. They are real. You have them. I have them. We all have them and that can lead you to overestimate your skills and underestimate the risks associated in performing complex tasks that are not your main area of expertise. In my experience this can and does have a detrimental effect on many investors' financial health. So, what can we do about it?

Well, even the fact of being aware that cognitive bias exists can help you be a better steward of your wealth. Knowing that you have a blind spot can help you to ask the right questions and even better, get answers. So, seek out trusted advice, keep your own counsel and remember,

"there are known knowns. There are things we know we know. We also know there are known unknowns. That is to say, we know there are some things we know we do not know. But there are also unknown unknowns. The ones we don't know we don't know." Donald Rumsfeld, February 12, 2002



Cheers!