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Our brain's clumsy irrationality

Research is about getting 'facts'. Or so I used to think. When someone fills in a questionnaire, or replies to a question, they are telling you the 'truth'. By combining truths from lots of respondents, you can 'prove' what the 'facts' are about a market, product or wotnot. But no one really believes that old hocum any more.

The real 'fact' is that there are no facts when it comes to divining what people think. Our brains don't work that way. There are too many factors which can distort, or filter our perceptions. I was reminded of this reading Garth Sundem's "Geek Logik: 50 Foolproof Equations for Everyday Life". "We seem doomed" says Professor Sundem cheerily, "to blunder through life led by our brain's clumsy irrationality".

The professor reminds us of the power of suggestion to distort our so-called objectivity. "Imagine", he says, "if I handed you a cup of hot coffee and then asked your opinion about a person whom you had recently met; now suppose I instead handed you a cup of ice-cold soda. Experiments show that your opinion of this person would be different because you have been primed to feel warmth or coldness".

Professor Sundem offers us a helpful list of other factors which can distort the way we see the world.

'Framing' for example, means that how you present data is as important as the data itself. 'Confirmation bias' is seen when people recognise only that data that supports their hypothesis. 'Loss aversion' happens when we stand to gain more than we would lose, but our fear of loss prevents us from being rational.

'Rosy retrospection' is something we all recognise. It means you forget the bad elements of a past experience, and remember the good. This is "integral to the repeated experience of family Christmas", says Professor Sundem. And it is this rule which helps to explain to me why women want to go through childbirth more than once!

But the one distortion which is most relevant to us right now is 'Impact bias' which can lead to overestimation of possible outcomes. In other words, people seem to think that if disaster strikes it will take longer to recover emotionally than it actually does. Conversely, if a happy event occurs, people overestimate how long they will emotionally benefit from it. I encountered this in a recent survey to measure the current mood in European Asset Management. As you will see if you look at the report (which is available in full for free at http://www.spencejohnson.com/Publishedwork.html) opinions vary widely from extreme optimism to extreme pessimism. Bear with me while I tell you the results in summary.

After allowing for the extremes, the overall mood is not as bleak as I had expected. I called the report "A frost in the garden", picking up on one respondent's phrase - frost is terminal for some plants, but other plants quite like it. There appears to be more pessimism than optimism around in the marketplace, and some are quite happy with this new environment. For example, some see 'frost in the garden' as helping to weed out low quality competitors who have been cluttering the market in the good years.

The recent downturn has apparently not prompted much strategic change - European strategic plans put in place last year continue to be executed as before. Having said this, many will shrink their budgets, particularly in marketing, IT and HR - a third will cut some or all of these. Some recruitment is frozen, but in contrast many are increasing their hiring.

Several parts of the industry continue to thrive. Institutional clients for example, are proving less reactive to the current conditions than the retail (who of course continue to redeem en masse). Yes, sure, it is not ideal - some institutions are postponing mandate related decisions, and they are being very 'needy'for information, and client service and support.

And there are some visible hotspots in product demand. Those active in developing markets continue to enjoy real success. True, some big changes are being seen in what clients want to buy - but successful hot products now include Agriculture and Developing Market funds.

The downturn is predicted to last between 9-36 months - there is no consensus on what will happen. For example, on a show of hands after the survey presentation among 40 asset management leaders, a fifth thought we faced significant further fund redemptions during the rest of 2008, a third saw them stabilising, and the remaining half saw a significant return towards positive net sales.

The reactions I have received since my presentation have varied wildly, from the pessimists – "The optimists you spoke to are just kidding themselves. We haven't seen the half of it yet" – to the optimists – "There are some real gloom-mongers in your study, but they tend to be infected by the scene in the US. In Europe, the institutional market is doing OK. More than OK, in fact."

Which brings me back to my point about 'Impact bias'. There is bound to be exaggeration (both towards optimism and pessimism) in what we say to each other in the current climate. The value of research is to understand this, and to discount those extremes. If the middle way represents a meaningless average in some circumstances, in this context it is a useful way of stripping views of their distortions. In reality, right now most asset management leaders are quite calm, and less inclined to panic than many may fear.

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