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Article

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Due Diligence and Bad Assumptions

By L Burke Files, CDDP, President, Financial Examinations & Evaluations, Inc (01/04/2012)

There are no disasters, only flaws in your assumptions. Brutal, but accurate.

We go though life with many assumptions about life, and many of them are flat wrong. We are lulled into believing that we understand the world around us and that it can be accurately measured and quantified and that all contingencies can be properly planned for. So let’s test our assumptions.

One thing we are all familiar with is death:

So what is the leading cause of death from these three?Alzheimer’s, Diabetes or Accidents?[i]

What animal has killed more humans than all of the wars ever fought?[ii]

Which kills more people each year, firearms, medical doctors or mosquitoes?[iii]

See - your assumptions are wrong, even about death. So why should your assumptions about life and commerce be any better? In short, as a whole - they are not.

Why are you very smart people (I judge you to be very smart because you are not only reading the IFC Review posts but also my article.) so prone to error?

We possess a large wonderful brain with elegant thought processes that are both intuitively wise and ultimately lazy. We celebrate and suffer from...

Heuristics and Biases

Heuristics are cognitive strategies people use to make assessments or judgments of probability simpler. We use heuristics to filter information from noise so that we can make quick perceptive choices. Also known as intuitive inferences, this process is used when we lack sufficient information to judge the probability of outcomes - so we generalise.

Heuristics can often lead to systematic choice errors when applied, as these choices rely on information that is subject to many **biases** as it is sampled and categorised.

These filters we use, and our preconceived notions, are biases. Biases that are left unchecked or when we are unaware of them and their impact - produce systemic and large errors.

For example, you are a caveman, and you hear a crinkle of leaves behind you. You are unlikely to commission a study on the origin of the noise of crinkling leaves - if you did, you may have to convene such a meeting in the belly of a Saber-toothed Tiger. That quick assumptive brain today may look at a prospective client and say, gee that is a very nice suit - excellent tailoring, good haircut - and thus he must know what he is talking about. You can’t help it – it’s OK - it’s your primitive part of the brain using heuristic strategies to help you make quick choices. You have a bias that well-groomed men in bespoke suits must be knowledgeable. For me the better they look and sound the more I lean toward unremitting suspicion - but that’s me.

So why do we make these choice errors... for an example on the death issue, your choice



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making is facing an availability heuristic and an availability cascade bias.

We judge the frequency of objects and events based upon the heuristic of availability or recollection of objects and events in our mind – all of which are distorted by the process of perception. These are very powerful and personal distortions. War is perceived to be a major cause of death, when in actuality you are five times more likely to take your own life as to die in a war (war .3 per cent, suicide 1.53 per cent). Even more dangerous are auto accidents at 2.09 per cent. The leading causes of death are heart disease at 29.34 per cent and infections at 19.12 per cent. We are willing to get in a car and drive, but not to exercise or eat smart. Why?

An availability cascade bias is a self-reinforcing process where a collective belief gains credibility through repetition. Our recall is from the news of accidents and wars - not of suicides, mosquitoes, or heart attacks. We come to conclusions based upon the availability of events we can recollect, for example, from reports in the media - not from an impassionate analysis.

There are so many others we face in our business such as government bonds are a good investment, (I have a collection of Latvian Gold Back Bonds, and some old Argentine and Greek Bonds), real estate is a good investment, (I have seen property lose over 70 per cent of its value here in the US), and bankers are wise investors (banking, in the latest disaster lost more money they have ever made in the history of banking).

I challenge you to think more about your heuristics and biases and how they colour the choices you make in your lives and in your firms. This process is so well understood by advertisers that they incorporate ways to enchant (read deceive) your intuitive side into advertisements to get you to buy stuff. As Daniel Kahneman has wisely observed, that we think both slow and well reasoned and fast and intuitively - and both methods of thought are important and needed. One just needs to know whether to rely on instinct or facts, or may be both.

There is much written about heuristics, biases and our bad assumptions, the best written by Amos Tversky and Daniel Kahnman - find some and read it.

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- [i] In the US according to the CDC for 2010, Alzheimer's - 79,003, Diabetes - 68.705, Accidents 118,021. Leading cause of death - Heart Disease 599,423
[ii] Fleas have the distinction of killing more people than all the wars man has ever fought. The "Black Death" plague killed 1/4 of Europe's population in the 14th century, caused by germs transmitted from rodents to humans by fleas.
[iii] Iatrogenic deaths each year substantially outnumber deaths by firearms and the mosquito kills more than both at about 2 - 3 million deaths per year.

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