After the fact explanations always have perfect hindsight...

February 9, 2018 12:30pm by Barry Ritholtz

I am constantly amazed by the endless explanations telling us — after the fact what just happened in the markets.

Later today, I will look at some of these explanations but before hand, a few words on the Narrative Fallacy and Hindsight Bias.

These two cognitive foibles help to explain why the after-the-fact explanations that occur following significant events – like the correction of the past 10 days – are so precision and filled with confidence. Long experience teaches us that both are usually unfounded.

The Narrative Fallacy reflects our tendency to see the world as a story (http://lesswrong.com/lw/14q/why_youre_stuck_in_a_narrative/): “a linear chain of cause and effect, with a beginning and an end.” We create a screenplay in our heads, a battle between forces of good and evil, with each event leading to the next logical step, until we reach a conclusion and denouement. This
oversimplification of reality is blind to nuance yet sees cause and effect where none exist. Randomness is a more difficult concept to accept as an underlying driver of events than the more comforting concept of causation.

“Messages that are framed as stories more memorable, easy to understand, and convincing,” noted Brett and Kate McKay (https://www.artofmanliness.com/2015/04/29/beware-the-too-compelling-narrative/), “Psychologists have found that the human brain is primed for narrative.”

Hindsight Bias takes our story telling a step further: not only do we create these narratives to help explain what just happened, but after the fact we believe we knew it all along. Unexpected events, after they occur, seem obvious and predictable (http://journals.sagepub.com/doi/abs/10.1177/1745691612454303), “despite there having been little or no objective basis for predicting it.” [i]

More on this later... See this (http://ritholtz.com/2018/02/congratulations-its-a-correction/)

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[i] Interestingly, “Hindsight bias is not only affected by whether or not the outcome is favorable or unfavorable, but also the severity of the negative outcome” (emphasis added). (Hindsight Bias In Legal Decision Making (https://guilfordjournals.com/doi/abs/10.1521/soco.2007.25.1.48), Erin M. Harley).

This is especially significant to traders and investors who tend to take market surprises and rationalize their understanding of them. This is likely why so many people today claim to have predicted the Great Financial Crisis of 2008-09 coming, despite all evidence to the contrary.

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