Heuristics & Biases

Part 3

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Familiarity Heuristics

"risk-taking behavior"

"Willingness to take risk"

risk-return

loss aversion, break-even effect

snakbit effect

ambiguity aversion

judged probability

"feeling of being competent"

"competence hypothesis"

The feeling of the relativity of what we know to what can be known

familiarity

overconfidence

Q:

Two new projects

same judged prob. of success

new territory

old territory

which one the CEO would go for?

"preference for the familiar" & "insufficient diversification"

less ambiguity aversion (less fear of the unknown) ← more competent ← more familiarity

Familiarity

- People are more likely to accept a gamble if they feel they have a better understanding of the relevant context, that is, if they feel more competent.

The competence hypothesis

- The willingness to bet on an uncertain event depends not only on the estimated likelihood of that event and the precision of that estimate;
- it also depends on one's general knowledge or understanding of the relevant context.

Heath, C., and A. Tversky, 1991, "Preference and belief: Ambiguity and competence in choice under uncertainty," Journal of Risk and Uncertainty 4, 5–28.

The competence hypothesis

- The competence hypothesis proposes that, holding judged probability constant, people prefer to bet in a context where they consider themselves knowledgeable or competent than in a context where they feel ignorant or uninformed.

Heath, C., and A. Tversky, 1991, “Preference and belief: Ambiguity and competence in choice under uncertainty,” Journal of Risk and Uncertainty 4, 5–28.

Familiarity

- Our feeling of competence in a given context is determined by what we know relative to what can be known.

- Thus, it is enhanced by general knowledge, **familiarity**, and experience, and is diminished, for example, by calling attention to relevant information that is not available to the decision maker, especially if it is available to others.

Familiarity

- **Familiarity** might help explain why investors are sometimes willing to forego the advantage of diversification and concentrate on a small number of companies (Blume, Crockett, and Friend, 1974) with which they are presumably familiar.

Blume, Crockett, and Friend, 1974, “Stock Ownership in the United States: Characteristics and Trends,” Survey of Current Business

Kaplan, Elle, 2017,“The Familiarity Heuristic: Why Most Investors Make This One Mistake”
https://www.lexioncapital.com/familiarity-heuristic-investors-make-one-mistake/

Familiarity vs. Ambiguity Aversion

- Heath and Tversky (1991) argue that ambiguity aversion has much to do with how competent an individual feels he is at assessing the relevant distribution as well.

- Ambiguity aversion over a bet can be strengthened by highlighting subjects' feelings of incompetence.

Familiarity vs. Ambiguity Aversion

- In situations where people feel especially competent in evaluating a gamble,
  - they will be less ambiguity averse,
  - they will exhibit a "preference for the familiar”.

Familiarity & Ambiguity Aversion

- Ambiguity and familiarity offer a simple way of understanding insufficient diversification.

Barberis &Thaler (2003)

Familiarity & Ambiguity Aversion

- Investors may find their national stock markets more familiar or less ambiguous than foreign stock indices;
  - they may find firms situated close to them geographically more familiar than those located further away;
  - they may find their employer's stock more familiar than other stocks.

Barberis &Thaler (2003)

Familiarity & Ambiguity Aversion

- Since familiar assets are attractive, people invest heavily in those, and invest little or nothing at all in ambiguous assets.

- Their portfolios therefore appear undiversified relative to the predictions of standard models that ignore the investor's degree of confidence in the probability distribution of a gamble.

Barberis &Thaler (2003)

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