



# Heuristics & Biases

Part 3

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# Familiarity Heuristics



"risk-taking behavior"  
 "Willingness to take risk"

risk-return

loss aversion, break-even effect

sunkist effect

ambiguity aversion

judged probability

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

"feeling of being competent"

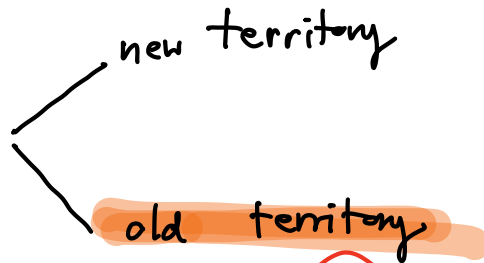
"competence hypothesis"

familiarity

↑ ↑ ↑  
 . . . . . overconfidence

Q:

Two new projects  
 same judged prob. of success



which one the CEO would go for ?

"preference for the familiar"



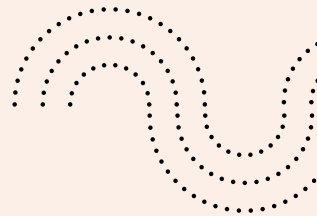

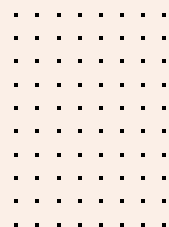
& "insufficient diversification"

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.
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# 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.

# 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.

# 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.



# Familiarity & Ambiguity Aversion

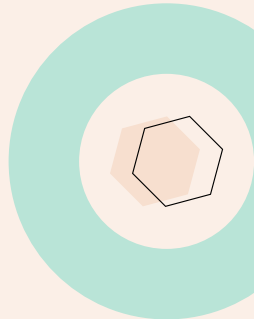
- Investors may find their national stock markets more familiar or less ambiguous than foreign stock indices;
  - they may find firms situated close to them geographically more familiar than those located further away;
  - they may find their employer's stock more familiar than other stocks.





# 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.





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