Investors' Chronicle

Investing explained

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How to overcome investor biases

Investing has as much to do with behaviour as it does with spreadsheets. As Morgan Housel, author of the Psychology of Money puts it "Investing is not really about what you know, it's about how you behave".

Behavioural economists have identified hundreds of psychological biases that can influence the way we make decisions about our finances. Below are some of the most common.

It is important to reflect on your own behaviour and understand what biases you are most prone to. Then you can control for them, making yourself a better investor in the process.

1. Loss-aversion bias

Investors have a hypersensitivity to losses, which can lead to bad investment decisions in times of extreme market volatility. This concept, known as loss-aversion, was first outlined in 1984 by economists Daniel Kahneman and Amos Tversky, who carried out a series of experiments which showed that people tend to fear a loss twice as much as they welcome an equivalent gain.

This can lead to panic selling because stocks have fallen, and then missing out on gains as they recover. Loss-aversion can lead people to sell stocks when they ought really to be buying more.

But it's also important to remain flexible and reassess the fundamentals of what you are investing in. While you should avoid crystallising losses on companies that look well-placed to recover, it can be equally damaging to hold on to companies that are likely to fall further.

Holding on to poor-quality stocks can also mean that you do not put the money invested in them to better use elsewhere.

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What's in this guide?

P1. Loss-aversion bias

P2. Overconfidence and confirmation bias

P3. The endowment effect and outcome bias

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2. Overconfidence

Evidence of our overconfidence is everywhere: from frequent underestimates of the cost of high-profile infrastructure projects, to surveys that consistently show the vast majority of people consider themselves better than average at anything ranging from driving skills to moral character.

Michael Mauboussin, author, finance professor and head of consilient research at Morgan Stanley Counterpoint Global, suggests it is useful to break overconfidence into three key areas:

- “overestimation” of one's own abilities;
- “overplacement” of how good oneself is compared with others; and
- “overprecision” based on belief in our own ability to answer difficult questions (and sometimes unanswerable ones!).

He considers the third issue the most problematic when it comes to investing.

Our biggest mistakes tend to occur when we are most confident. This is a particular issue in our information-rich age as confidence tends to grow, the more information we have at our disposal. That’s even though there is often little relationship between accumulation of information and the quality of the decisions people make.

Another dimension to overconfidence is that we tend to require very little evidence to accept new ideas. The problems associated with this particular trait are compounded by the difficulties we have in rejecting ideas once we've accepted them, as we’ll find out next.

3. Confirmation bias

It is human nature to look for facts that support and confirm what we already believe while ignoring or explaining away anything contradictory. In 2009, the American Psychological Association assessed 91 studies into this phenomenon covering 300 independent groups and 8,000 participants. It found that people were more than twice as likely to favour information that confirmed their view than went against it.

Confirmation bias also extends to the company we keep. An innate desire to surround ourselves with people who think like us is a key contributor to the often-disastrous phenomenon known as 'groupthink'. Social networking sites can contribute to this issue.

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Confirmation bias is particularly insidious when precise cause and effect are very hard to understand, as is the case with investing. Under these circumstances, facts are altogether more malleable and can easily be corralled to suit a preferred argument.

4. The endowment effect

The endowment effect describes our tendency to put more value on things when we own them. This has major implications for investors making decisions to buy or sell. In particular, it suggests investors are prone to fall in love with certain investments and hang on to them for too long.

Research consultancy Essentia Analytics has found that the performance of many investments by professionals resembles a "reverse horse-shoe"; big gains early on that are subsequently given back over the lifetime of an investment due to reticence to sell. Fund managers could create 1.2 percentage points of outperformance by selling their positions following a typical six-month "window of opportunity".

5. Outcome bias

The stock market is particularly poor at providing feedback to investors due to the difficulty of disentangling the influence of luck and skill when assessing outcomes. This is a key reason why investors face such major issues with outcome bias; our propensity to judge the quality of a decision based on its results rather than the quality of thought at the time the decision was made.

The problems of providing oneself with honest assessments on decision quality are compounded by the similar but distinct issue of hindsight bias; judging a decision based on information that was not known at the time.

Outcome bias, the roll of luck, and the long timeframes often involved in investing, all mean feedback on investment decisions tends to be poor despite the financial results being very tangible. Coupled with overconfidence, this means investors that keep getting lucky can misidentify skill in a flawed investment process right up until a calamitous day of reckoning. Equally, investors with a good process can give up on it due to a poor run of luck.

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How to overcome biases

Have a plan and write it down

- What is your strategy
- What criteria you want met for buying
- What criteria you have for selling
- What you plan to do in a market crisis

When you buy a company, jot down a few bullet points on your decision to purchase. This will help you review the position and identify when the investment case has changed, or you may wish to sell.

Review regularly

Write down your plan as though you were giving honest advice to someone else. This should help introduce some objectivity.

To prevent emotional decision-making, try not to make investment decisions in the heat of the moment. A rule to only make decisions after the market closes, for example, could significantly improve clarity of thought.

Write down:

- What you think the market is not pricing in
- By what objective indicator you will measure the success of your prediction
- What you think the probability of success is

Also set yourself reminders to regularly review the investment case.

Seek out different viewpoints

To avoid confirmation bias, seek out research that has a different point of view to you and check you are still happy with the investment case.

A way of improving decision-making that researchers have identified is to compare predictions to a 'base rate'. A base rate reflects what has happened in similar situations in the past.

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Michael Mauboussin, author, finance professor and head of consilient research at Morgan Stanley Counterpoint Global, compiled the free-to-access Credit Suisse Base Rates Book.

He says: "I think where [base rates] work most effectively is when we have well-behaved distributions of outcomes. So things such as revenue growth rates are not perfectly normally distributed – there's always going to be an extreme company because the distribution is going to shift over time – but for the most part, there's going to be a lot of value in applying [base rates]... Where the distributions are heavily skewed or even the notion of a mean average is nonsensical, it's going to get much more difficult."

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