Investment Behavioral Biases

How to recognize blind spots and overcome them

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I AM FAR FROM AN EXPERT in psychology. But having witnessed nearly four decade's worth of investor behavior, I have learned a few things about how people think and act when it comes to money and investing. Recognizing our tendencies and limitations is the first step in making better decisions.

Cognitive behaviors are built in mind sets to help us process information and survive. However, some of these can lead us to making poor decisions. Below are some examples of cognitive biases (blind spots) we all share as individuals and in groups.

Mistakes we all make[1]

- Over-optimistic – we believe we are less likely to have problems than others.
- Our emotions influence decisions more than we realize[2].
- We believe we are objective, prefer positive news and dislike admitting weaknesses.[3]
- We prefer to feel in control and often believe we can control uncontrollable events.
- We create stories to reinforce our decisions and justify poor outcomes.[4]
- We are twice as sensitive to losses as gains.[5]
- Confirmation bias - we seek selected data to support prior beliefs and draw conclusions.[6]
- We tend to overweight recent experiences and extrapolate.
- "Endowment effect" - once we own something we place a higher value on it than others.
- Anchoring - once we make a decision we stick to it.
- We resist change and protect our self-image.[7]
- We attribute good outcomes to skill, bad outcomes to bad luck or other reasons.
- Stories only need to be plausible, not accurate.[8] "Facts" are 50% more believable when told in the form of a story.

Tool for individuals

- Write down your thought process. Why did you do what you did? What you did not do?
- Write down the counter argument.
- Learn from mistakes. Written accounts help us identify our own mistakes.
- Discuss decisions with someone else.
- Use a financial advisor - they should have a sound process to help you understand yourself better and keep you on track.

Mistakes made by groups

- Collective rationalization – if we all agree we must be right.
- Belief in inherent morality – even if I am wrong it is/was the right thing to do.
- Stereotyped views of out-groups – those who hold other opinions are misinformed.
- Direct pressure on dissenters.
- Self-censorship - We want to be liked and don't want to be disagreeable[9] or seen as stupid.[10]
- Illusion of unanimity- we focus on information that most of the group share.[11]
- Those with higher seniority are deferred to.[12]
- Group decisions can be more extreme one way or the other, often too conservative.[13]
- Relationships between members influence how information is interpreted.[14]
- Responses to people and facts are influenced by our feeling safe or threatened.

"What gets us into trouble is not what we don't know. It's what we know for sure that just ain't so."

\- Josh Billings

Tools for group leaders

- Weaknesses must be admitted and admitting weaknesses must be seen as a strength.
- Being honest is better than looking good.
- Encourage people to question facts and challenge assumptions and conclusions.
- Encourage people to admit when they don't know things.
- Write down the "pros" and "cons", before you decide, and explore the cons as thoroughly as the "pros". ***This is much harder than it sounds***.
- Leaders must master the process to combat negative influences[15] and learn from their own mistakes.

Group meeting tactics

- Participants should write down their views prior to the meeting, comments can be read without attribution and evaluated without bias.
- Junior people should speak first, be sure all get to speak.
- Seek diversity in the group – gender, background, cultural and experience.

Lessons for all investors

CONCENTRATE ON PROCESS. The world's greatest investors have integrated set of rules that govern the way they approach investing. They codified the process because they know that unless they force themselves to behave they will slip back into old habits.

THESE TENDENCIES may help explain why the annual DALBAR studies reveal why investors actual returns are significantly less that the "market averages"[16] and why, over longer periods of time, investors in "actively managed" funds exceed investor results in "passively managed" funds. [17]

Conclusions

If we want to become better decision makers we need to understand the "human factors" in the process and adjust accordingly. To paraphrase Socrates, to know thyself is the first step towards making better decisions.

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