Investment Biases –

Know Them to Tame Them

Whether we like it or not, we live in a biased world, and financial markets are no different. It has been proven over time that investors buy high and sell low, precisely because their cognitive and emotional biases prevent them from taking rational decisions.

It is fear and greed that takes markets through booms and busts — a roller-coaster that investors could mitigate by simply being aware of which are the most common investment biases and how to address them.

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- ☐ Concept
- ☐ Manifestation
- ☐ Consequence
- ☐ How to Overcome

COGNITIVE

These biases stem from our informational, computational or rational limitations.
They may be overcome with information, advice, experience and education.

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	Concept	Manifestation	Consequence	How to overcome
Conservatism	Fail to adapt to new information.	React slowly to new data, ignore information that is complex to process. Stick to previous ideas.	May hold investment too long.	Look carefully at new information.
Confirmation	Look for information that supports one's view; focus on the positive, ignore the negative.	Reject new information that provokes discomfort (cognitive dissonance).	May hold investment too long.	Seek out contrary views.
Representativeness	Turning a single point / data / event into a wider trend.	A company may have positive earnings and an investor may conclude that the business has good momentum, when profits could have been driven by one-off events.	Wrong decisions: investors may also sell too soon following a corporate one-off negative blip, missing potential future gains.	Have a long-term view.
Illusion of Control	Think you can control an outcome when you can't.	A person owning a large part of his/her corporate stock in his/her pension portfolio because they believe they can have an impact on the firm's future.	Asset concentration, failure to diversify.	Seek other people's opinions outside one's circle.
Hindsight	Selective memory of past events / seeing events as more predictable than what they really are.	"I knew it all along"-mentality. Investors overestimate the rate at which they correctly predicted events.	Overconfidence in one's abilities.	Keep a record of pre-event predictions, not post-event.
Anchoring & Adjustment	Anchoring one's views to a specific point.	Investors may be stuck on a price: If an investor buys at 15 and the price is 20, they are happy; but if the stock falls from 25 to 20, they are not, even if the gain would be the same.	Decisions are not taken based on rational investment logic.	Reference back to one's original goal or plan.
Mental Accounting	Money is treated differently depending on how it is categorised.	People feel they can freely spend bonus money, but not wage income, when money is fungible (indivisible).	Portfolios may be structured in layers, with an overweight on income as people believe that income money can be spent; they are more reluctant to withdraw any money generated by capital gains, hence reducing capital-generating allocations.	See one's portfolio as a whole, focus on total return. This will also improve the variance/correlation profile of the portfolio.
Framing	Decisions are affected by the order in which the question/data is framed.	People tend to choose the first option.	Fail to properly assess risk.	Ask whether the decision is based on whether it will generate a gain or a loss.
Availability	Putting more emphasis on information that is readily available.	Favour the data/events that are easier to recall.	Portfolios may be undiversified; investors may overreact to market conditions or too much media attention. May lead to concentrated portfolios.	Keep a long-term mindset.

EMOTIONAL

These biases are more deeply ingrained in our minds than cognitive ones, and therefore more difficult to eradicate. Simple awareness may be the best way to mitigate their effects.

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	Concept	Manifestation	Consequence	How to Overcome
Loss Aversion →	People usually get more pain from a loss than pleasure from a gain.	People may take risks to avoid losses, but are conservative in terms of gains. It usually takes a gain of $20 to offset the pain of losing $10.	We may hold on to losing investments because it is too painful to realise the loss, but may sell winners too quickly as we don't mind taking a small profit, forgoing potential upside.	Focus on investment prospects, not perceived gains or losses.
Overconfidence →	Overestimate one's capacity.	Believing we know and/or are more experienced / wiser than others, or just more than what we really do / are.	Underestimate uncertainty and overestimate return. Under-diversify. Excessive turnover and transaction costs.	Have a better review process.
Self-control →	Lack of self-discipline, favour short-term, immediate gratification gains rather than long-term goals.	Incapacity to save or invest in a disciplinary manner.	Insufficient savings for retirement; too much risk in the portfolio, too much emphasis on income.	Establish a plan and a budget.
Status-quo →	Unwillingness to make changes.	Focus on keeping what one has.	Holding portfolios with inappropriate levels of risk. Invest by inertia, losing out on new and better opportunities.	Seek education about other options.
Endowment →	Believing that the assets that we hold are better than what they really are.	Keeping assets for sentimental reasons, even if they are not sound investments. Common in situations of inheritance.	Holding on to assets at a high opportunity cost.	Ask oneself: would I buy this asset today?
Herding →	Doing what the others do.	Following market noise or friends' advice.	The loudest voices may not be the soundest. Many investors buy at the top of the market, only to see the price of their asset drop.	Ask whether the decision is taken based on fundamentals.

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