7 Most Common Biases Impacting Investors

Capital Partners
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Investors exhibit many biases. Few of these behavioural biases exist in isolation because deep interactions exist among different biases. Nonetheless, the following list represents some common biases facing investors but others may be equally important depending on the specific situation.

1. Representativeness.

Representativeness results in investors labelling an investment as good or bad based on its recent performance. Consequently, they buy stocks after prices have risen, expecting those increases to continue and ignore stocks when their prices are below their intrinsic values.

Investors should have a clearly defined analytical process that they test and retest in order to refine and improve it over the long run.

2. Regret (loss) aversion.

Regret aversion describes the emotion of regret experienced after making a choice that turns out to be either a bad or inferior choice. Investors who are influenced by anticipated regret are motivated to take less risk because this lessens the potential of poor outcomes. Regret aversion can explain investor reluctance to sell “losing” investments because it gives them feedback to make bad decisions. Disciplined investing requires overcoming the reluctance to realise losses.

3. Disposition effect.

Closely related to regret aversion is the disposition effect, which refers to the tendency of selling stocks that have appreciated in price since purchase (“winners”) too early and holding on to losing stocks (“losers”) too long. The disposition effect is harmful to investors because it can increase the capital gains taxes that investors pay and can reduce returns even before taxes.

Following the advice of “cut your losses and let your profits run” enables investors to engage in disciplined investment management to generate higher returns.

4. Familiarity bias.

This bias occurs when investors have a preference for familiar investments despite the seemingly obvious gains from diversification. Investors display a preference for local assets with which they are more familiar (local bias) and portfolios tilted toward domestic securities (home bias). Familiarity bias implies that investors hold suboptimal portfolios. To overcome this bias, investors need to cast a wider net and expand their portfolio allocation decisions to gain wider diversification and risk reduction.

Investing internationally helps to avoid familiarity bias.

5. Worry.

The act of worrying is an ordinary and unquestionably widespread human experience.

Worry educes memories and visions of future episodes that alter an investor’s judgment about personal finances. Based on survey evidence, a much larger percentage of responding investors associate the word “worry” with common stocks (70 per cent) as compared to bonds (10 per cent). More anxiety about an investment increases its perceived risk and lowers the level of risk tolerance among investors.

In turn, this concern increases the likelihood that investors will not buy security. To avoid this bias, investors should match their risk tolerance level with an appropriate asset allocation strategy. As a quick test, if investors cannot sleep because of apprehension about their investments, they probably should have a more conservative and hence less risk investment portfolio.

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6. Anchoring.

Anchoring tends to hold on to a belief and then apply it as a subjective reference point for making future judgments. Anchoring occurs when an individual lets a specific piece of information control his cognitive decision-making process. People often base their decisions on the first source of information to which they are exposed (e.g., an initial purchase price of a stock) and have difficulty adjusting or changing their views to new information.

Many investors still anchor on the financial crisis of 2007-2008 as a bad experience. As the survey notes, this results in a higher degree of worry, which can cause them to underweight equities in their portfolios because they are excessively risk- and loss-averse. To avoid anchoring, investors should consider a wide range of investment choices and not focus their financial decisions on a specific reference point of information.

7. Trend-chasing bias.

Investors often chase past performance in the mistaken belief that historical returns predict future investment performance. Mutual funds take advantage of investors by increasing advertising when past performance is high to attract new investors. Research evidence demonstrates that investors do not benefit because performance typically fails to persist in the future. For example, using a sample of 1,020 domestic actively managed mutual funds, Soe and Luo (2012) show that using past performance as a strategy fails.

For the five years ending March 2012, only about 5 per cent of the funds maintained top-half performance rankings over five consecutive 12-month periods, while 6 per cent were predicted to repeat by chance alone.

To avoid this bias, investors should resist following the herd or jumping on the bandwagon. Although investors may feel better when investing with the crowd, such an investment strategy is unlikely to lead to superior long-term performance.

These seven behavioural biases are some fundamental issues investors might face at different periods during their lifetimes. Another important issue to consider is the amount of attention and time they should spend on their investment decisions because this might result in overconfident or status quo behaviour. *"By avoiding behavioural biases, investors can more readily reach impartial decisions based on available data and logical processes."*

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