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Behavioral Economics and Investing

Behavioral economics as a discipline studies both the psychological and economic factors which ultimately drive our decision-making. While human beings would like to consider themselves rational decision-makers, decades of scientific research have demonstrated that irrationality ultimately prevails. Individuals tend to be driven by emotion and subconscious biases which often lead them to act against their own best interests. This concept is readily apparent in investing where emotion can lead to costly mistakes. The only means of counteracting the harmful influence of cognitive biases is through awareness. Consider the following list:

ANCHORING: The tendency to fixate or "anchor" our thinking to a point of reference—even though it may have no logical relevance to our current decisionmaking.[1] For an investor, the historical value of a stock may serve as an anchor even though this has no correlation to current market pricing. This may lead to irrationally buying in on a stock which has fallen significantly. The investor believes the stock is undervalued because it has fallen so far from its highs—the anchor—when indeed the current low price reflects a change in market fundamentals.

AVAILABILITY BIAS: the tendency to significantly weight decisions in favor of more recent information.[2] New opinions formed are thus biased towards the latest news. This manifests itself in investing when investors overreact to negative news and disproportionately drive down prices. The opposite can also be true where good news results in over-exuberance.

CONFIRMATION BIAS: The tendency to seek and fixate on information which confirms some preexisting thought while rejecting data which contradicts it.[3] An investor that is particularly bullish some particular stock may conduct research that seeks to prove its potential. They are likely to fixate on the positive information they find while disregarding the red flags they should actually be focusing on.

ENDOWMENT EFFECT: The bias which occurs when we overvalue something that we own, regardless of its objective market value.[4] An investor may be irrationally attached to assets they have procured even in the face of market fundamentals which point elsewhere. This emotional attachment may hinder the investor's assessment of true market value.

GAMBLER'S FALLACY: when an individual mistakenly believes the occurrence of a particular event is less likely to happen following an event or series of events.[5] Consider a coin toss where the previous 5 tosses have all landed tails. A gut feeling might lead us to believe the next toss must be heads—in fact the odds of each individual toss remain 50/50. Say some investors think the market must go up soon because it has been down the past year. They are not basing their belief in evidence but rather a gut feeling that can lead them astray.

LOSS AVERSION: The idea that "losses loom larger than gains."[6] There is an innate tendency to be disproportionately risk-averse due to the psychological pain associated with losses. Nobel laureate in economics Daniel Kahneman explains that "loss aversion causes investors to overweight losses relative to gains and therefore leads to flawed investment decision-making."[7] Investors may allow fear to drive their actions and avoid opportunities they would otherwise consider.

OVERCONFIDENCE: The fallacy of overestimating or exaggerating one's ability to successfully perform a particular task.[8] An investor's hubris can cause him to believe he knows more than he really does and, as a result, hinder himself by failing to seek out more information. Overconfidence that we know more than others and can beat the market can result in disastrous losses.

STATUS QUO BIAS: The tendency to get a bit too comfortable with the current state of things.[9] This predisposition stems from the false belief that the good times, such as the current bull market, will last forever. Investing in passive equity strategies may have provided good returns in the past; however, it would be a fallacy to assume the same will continue to be true in the future.

SUNK COST FALLACY: The tendency to continue a current commitment as a direct result of previously invested resources.[10] Individuals will continue to pursue a task even in the face of incurring added costs—be it money or time—on top of their initial outlay. This fallacy hinders investors when they simply cannot cut their losses. The stocks they bought have dropped precipitously, but rather than selling low they double down and buy more. The failure to admit a poor past decision later results in even worse future outcomes.

We must stay constantly vigilant of how these biases can impact our day-to-day decision making. As financial stewards, it is our duty to be aware of these risks and potential pitfalls. While there is no means of avoiding bias entirely, we can seek to implement strategies which help mitigate their effects.

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