Insight

How Biases Affect Investor Behaviour

By H. Kent Baker and Victor Ricciardi

Investor behaviour often deviates from logic and reason, and investors display many behaviour biases that influence their investment decision-making processes. Below, H. Kent Baker and Victor Ricciardi describe some common behavioural biases and suggest how to mitigate them.

"The investor's chief problem – even his worst enemy – is likely to be himself."

Benjamin Graham

Why do investors behave as they do? Investor behaviour often deviates from logic and reason. Emotional processes, mental mistakes, and individual personality traits complicate investment decisions. Thus, investing is more than just analysing numbers and making decisions to buy and sell various assets and securities. A large part of investing involves individual behaviour. Ignoring or failing to grasp this concept can have a detrimental influence on portfolio performance.

Behavioural biases in investing encompass many types. For example, cognitive biases refer to tendencies to think and act in certain ways. A cognitive bias can be viewed as a rule of thumb or heuristic, which can lead to systematic deviations from a standard of rationality or good judgment. Some controversy still exists about whether some of these biases are truly irrational or whether they result in useful attitudes or behaviour. Other biases are more emotional in nature. An emotional bias is one that results in taking action based on feelings instead of facts. Given that some overlap exists between cognitive and emotional biases, we simply call them behavioural biases. An important aspect of avoiding such biases is to become aware of them. Thus, by avoiding behavioural biases investors can more readily reach impartial decisions based on available data and logical processes.

Our purpose is to briefly discuss investor behaviour, review eight common behavioural biases, and then concentrate on two types of investors – overconfident investors and status quo investors. Baker and Nofsinger (2002, 2010) and Baker and Ricciardi (2014) provide more detailed discussions of investor behaviour including behavioural biases.

Investor Behaviour

What is investor behaviour? The field of investor behaviour attempts to understand and explain decisions by combining the topics of psychology and investing on a micro level (i.e., the decision process of individuals and groups) and a macro level (i.e., the role of financial markets). The decision-making process of investors incorporates both a quantitative (objective) and qualitative (subjective) aspect that is based on the features of the investment product or financial service. Investor behaviour examines the mental processes and emotional issues that individuals, financial experts, and traders reveal during the financial planning and investment management process. In practice, individuals make judgments and decisions that are based on past events, personal beliefs, and preferences. They establish short cuts or heuristics that can save time but lead them away from rational, long-term thinking.

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Understanding investor behaviour can inform investors about these biases and help them improve their decision-making processes in selecting investment services, products, and strategies. As a result of the financial crisis of 2007-2008, the discipline of psychology began to focus even

more on the financial decision-making processes of individuals. This renewed interest by the social sciences and business disciplines has spurred new research on investor behaviour.

Common Behavioural Biases

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. Baker and Nofsinger (2002), Ricciardi (2008), iShares (2013), Parker (2013), and Seawright (2012) provide further discussion of behavioural biases and how to deal with them.

1. **Representativeness**. Representativeness results in investors labeling 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 that they have made 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 that can 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) as well portfolios tilted toward domestic securities (home bias). An implication of familiarity bias is 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.

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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, Ricciardi (2011) finds that a much larger percentage of responding investors associate the word "worry" with common stocks (70 percent) as compared to bonds (10 percent). 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 the security. To avoid this bias, investors should match their level of risk tolerance 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.

6. **Anchoring.** Anchoring is the tendency 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 Ricciardi (2012) 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. **Self-attribution bias**. Investors who suffer from self-attribution bias tend to attribute successful outcomes to their own actions and bad outcomes to external factors. They often exhibit this bias as a means of self-protection or self-enhancement. Investors afflicted with self-attribution bias may become overconfident, which can lead to overtrading and underperformance. Keeping track of personal mistakes and successes and developing accountability mechanisms such as seeking constructive feedback from others can help investors gain awareness of self-attribution bias.

8. **Trend-chasing bias.** Investors often chase past performance in the

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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 percent of the funds maintained top-half performance rankings over five consecutive 12-month periods, while 6 percent 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 eight 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.

Two Different Types of Investors

Most investors can be classified as either overconfident or status quo investors. Overconfident investors tend to be overly active traders and status quo investors display a lack of attention to managing their portfolios. The best advice is to find an appropriate balance between the two types of investors.

Overconfident Investors

Investors often exhibit overconfident behaviour resulting in severe consequences. They may display overconfidence in both the quality of their information and their ability to act on it. Ricciardi (2008) observes that people tend to overestimate their skills, abilities, and predictions for success. Research documents that overconfident behaviour is connected to excessive trading and results in poor investment returns. It can also lead to investors failing to appropriately diversify their portfolios.

Barber and Odean (2001) study the role of trading behaviour and gender bias for a sample of 35,000 individual accounts over a six-year period. Their findings reveal that males are not only more overconfident about their investing abilities but also trade more often than females. Compared to women, men also tend to sell their stocks at the incorrect time resulting in higher trading costs. Women generally trade less and apply a "buy and hold" approach resulting in lower trading costs.

To resist this bias, investors need to recognise the signs of overconfidence such as attributing a few short-term "wins" to superior knowledge, abilities or skills. Short-term performance may be more a stroke of luck than security selection or market timing skill. Individual investors are unlikely to have better information, intuition or analytical powers than others. In fact, the market has made fools out of many respected but overconfident investment professionals. Ultimately, individuals should be investing for the long-term rather than trading for the short-term.

Status quo bias reveals the drawbacks of a simple "buy and hold" strategy for long-term investors. To resist this bias, investors should implement a disciplined investment strategy.

Status Quo Investors

Some Investors suffer from status quo bias in which they tend to default to the same judgment or accept the current situation. Changing this inertia requires strong motivation or incentives. Status quo bias occurs when investors fail to update their economic conditions despite potential gains from doing so. Instead, they stick to a position, such as holding a stock instead of selling it or otherwise act in a suboptimal manner. People also tend to defer savings for retirement or postpone opening a retirement account. After entering a 401k retirement plan, many employees do not

actively manage or monitor their accounts.

Mitchell, Mottola, Utkus, and Yamaguchi (2006) examine more than 1,500 company 401(k) plans with 1.2 million client accounts. Their evidence reveals that most savers exhibit severe inertia or inattention bias. Over a two-year period, most do not execute any trades.

Status quo bias reveals the drawbacks of a simple "buy and hold" strategy for long-term investors. To resist this bias, investors should implement a disciplined investment strategy based on a portfolio approach. For example, they should match their level of risk tolerance with a predetermined asset allocation. This asset allocation strategy may encompass a diverse collection of mutual funds including stocks, bonds, and real estate both nationally and internationally. Another way to overcome status quo bias involves rebalancing a portfolio at least yearly. This helps to ensure that an investor's risk tolerance profile matches his asset allocation throughout the life of the long-term portfolio. By using active asset allocation investors tend to shift gains from risky assets (stocks) during bull markets to safer assets (bonds). During bear markets, they reallocate gains in the safer asset class (bonds) to the riskier asset class (stocks). Although this active asset allocation provides less upside gains during bull markets, it lessens downside risk during bear markets.

Because experienced investors have learned that success comes from reining in emotions and overcoming their biases, they avoid making the same mistakes as new investors.

Concluding Remarks

Investors display many behaviour biases that influence their investment decision-making processes. We describe some common behavioural biases and suggest how to mitigate them. Although investors cannot avoid all biases, they can reduce their effects. This requires understanding one's behavioural biases, resisting the tendency to engage in such behaviours, and developing and following objective investment strategies and trading rules. Investors also need to invest for the long-term, identify their level of risk tolerance, determine an appropriate asset allocation strategy, and rebalance portfolios at least yearly. Because many experienced and seasoned investors have learned that success often comes from reining in emotions and overcoming their biases, they often avoid making the same mistakes as many new investors. EBR

The article draws on some themes and strategies from the authors' book *Investor Behavior - The Psychology of Financial Planning and Investing* published by John Wiley & Sons in 2014.

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