It's (Really)

All in Your Head

by Keith McKenzie

Ask yourself this simple question:

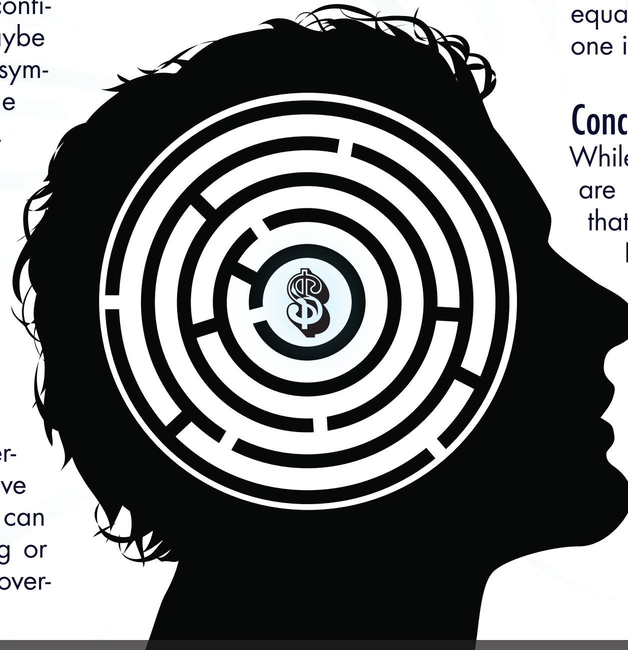
Do you consider yourself an above-average driver? Don't worry about false modesty – according to one famous study, 93% us do. Of course, given the definition of "average," one has to conclude that over 40% of us are overconfident in our own abilities. Okay, maybe the distribution of driving skills isn't symmetric and the average isn't the same as the median, but you get the point.

This is an example of a cognitive bias – put simply, a difference between how we see the world and how the world actually is. While these biases can be beneficial in some circumstances, in the realm of investing, they almost always cause people to make poor decisions. For example, overconfidence leads investors to believe that they (or the people they hire) can "outsmart" the market through timing or superior stock selection, while the overwhelming weight of the evidence shows that these activities are some of the primary reasons why most investors (and managers) significantly underperform the market over time.

As advisors focus on the long-term process of building and protecting our clients' wealth, we believe that recognizing and understanding these biases is crucial to having any hope of avoiding them. Accordingly, we invite you to consider a few other well-known examples – we suspect that some may sound all too familiar.

Anchoring and Extrapolation

Anchoring is the tendency to focus on how things were at some point in the (usually recent) past, while extrapolation is the corresponding tendency to assume that how things are today is how they will be in the future. Put together, these behaviors lead investors to make backward-facing decisions about the future, purchasing what recently did well (buying high) and getting rid of what recently fared worse (selling low).



"A little knowledge is a powerful thing."

Loss Aversion

It is said that the two main motivators when it comes to investing are fear and greed. As between the two, it is well-settled that fear is dominant – in other words, losses of a certain amount cause us significantly more pain than gains of the same amount give us pleasure. As a result, investors tend to sell into market declines, locking in their losses and all but guaranteeing that they will not be around to benefit when the inevitable rebound occurs.

Hindsight Bias

How many times have you looked back on the result of some event and thought to yourself, "I knew it all along!"? Welcome to hindsight bias – the inclination to see past outcomes as predictable, even though they were anything but before they took place. Unfortunately, the more one sees the past as predictable, the more one will think the future is equally predictable, and the more likely one is to repeat past mistakes.

Conclusion

While these biases (and many others) are powerful, there are some things that you can do to counter their effects. First and foremost, any time you are tempted to make a significant change to your investment strategy, take a step back and consider your motivations. Second, try to focus on overall asset allocation rather than market timing and stock-picking – you'll be less likely to give in to bad behavior. Finally, if possible, use the biases of others to your own advantage – a little knowledge is a powerful thing.

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