Behaviors That Can Cause Investment Mistakes

Examples of how certain biases can cause investment mistakes

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Cognitive Dissonance Bias

- Cognitive dissonance can cause investors to hold losing securities positions that they otherwise would sell because they want to avoid the mental pain associated with admitting that they made a bad decision.

- Cognitive dissonance can cause investors to continue to invest in a security that they already own after it has gone down (aver- age down) to confirm an earlier decision to invest in that security without judging the new investment with objectivity and rationality. A common phrase for this concept is "throwing good money after bad."

- Cognitive dissonance can cause investors to get caught up in herds of behavior; that is, people avoid information that counters an earlier decision (cognitive dissonance) until so much counter information is released that investors herd together and cause a deluge of behavior that is counter to that decision.

- Cognitive dissonance can cause investors to believe "it's different this time." People who purchased high-flying, hugely overvalued growth stocks in the late 1990s ignored evidence that there were no excess returns from purchasing the most expensive stocks available. In fact, many of the most high-flying companies are now far below their peaks in price.

Conservatism Bias

- Conservatism bias can cause investors to cling to a view or a forecast, behaving too inflexibly when presented with new information. For example, assume an investor purchases a security based on the knowledge that the company is planning a forthcoming announcement regarding a new product. The company then announces that it has experienced problems bringing the product to market. The investor may cling to the initial, optimistic impression of some imminent, positive development by the company and may fail to take action on the negative announcement.

- When conservatism-biased investors do react to new information, they often do so too slowly. For example, if an earnings announcement depresses a stock that an investor holds, the conservative investor may be too slow to sell. The preexisting view that, for example, the company has good prospects, may linger too long and exert too much influence, causing an investor exhibiting conservatism to unload the stock only after losing more money than necessary.

- Conservatism can relate to an underlying difficulty in processing new information. Because people experience mental stress when presented with complex data, an easy option is to simply stick to a prior belief. For example, if an investor purchases a security on the belief that the company is poised to grow and then the company announces that a series of difficult-to-interpret accounting changes may affect its growth, the investor might discount the announcement rather than attempt to decipher it. More clear-cut and, therefore, easier to maintain is the prior belief that the company is poised to grow.

ConfirmationBias

- Confirmation bias can cause investors to seek out only information that confirms their beliefs about an investment that they have made and to not seek out information that may contradict their beliefs. This behavior can leave investors in the dark regarding, for example, the imminent decline of a stock.

- When investors believe strongly in predetermined “screens,” such as stocks breaking through a 52-week price high, confirmation bias is usually at work. These investors only use information that confirms their beliefs. They may blind themselves to information that demonstrates that a stock breaking through its 52-week high may not make a good investment.

- Confirmation bias can cause employees to over concentrate in company stock. As IBM and other examples demonstrate, intraoffice buzz about a company’s prospects does not justify indiscriminate reliance by employees on company stock. People naturally tend to unduly emphasize evidence suggesting that the companies they work for will do well.

- Confirmation bias can cause investors to continue to hold under-diversified portfolios. Many practitioners have seen clients become infatuated with certain stocks—not always the stocks of employer corporations. Over the course of years, such a client might accrue a large position that ultimately produces a lopsided portfolio. These clients do not want to hear anything negative about favored investments but rather seek, single-mindedly, confirmation that the position will pay off.

Illusion of Control Bias

- illusion of control bias can lead investors to trade more than is prudent. Researchers have found that traders, especially online traders, believe themselves to possess more control over the outcomes of their investments than they actually do. An excess of trading results, in the end, in decreased returns.

- Illusions of control can lead investors to maintain under diversified portfolios. Researchers have found that investors hold concentrated positions because they gravitate toward companies over whose fate they feel some amount of control. That control proves illusory, however, and the lack of diversification hurts the investors' portfolios.

- Illusion of control bias can cause investors to use limit orders and other such techniques in order to experience a false sense of control over their investments. In fact, the use of these mechanisms can often lead to an overlooked opportunity or, worse, a detrimental, unnecessary purchase based on the occurrence of an arbitrary price.

- Illusion of control bias contributes, in general, to investor overconfidence. (Please see Chapter 18 for a detailed discussion of related pitfalls and compensation techniques.) In particular, investors who have been successful in business or other professional pursuits believe that they should also be successful in the investment realm. What they find is that they may have had the ability to shape outcomes in their vocation, but investments are a different matter altogether.

HindsightBias

- When an investment appreciates, hindsight-biased investors tend to rewrite their own memories to portray the positive developments as if they were predictable. Over time, this rationale can inspire excessive risk taking because hindsight-biased investors begin to believe that they have superior predictive powers, when, in fact, they do not. The bursting of the technology bubble is an example of this bias in action.
- Hindsight-biased investors also “rewrite history” when they fare poorly and block out recollections of prior, incorrect forecasts in order to alleviate embarrassment. This form of self-deception, in some ways similar to cognitive dissonance, prevents investors from learning from their mistakes. A clear example of this bias took place in the early 1980s, when energy stocks generated over 20 percent of S&P 500 returns, and lots of investors were caught up in the boom. By the 1990s, though, the energy bubble subsided, and many stockholders lost money. Most now prefer, in hindsight, to not recognize that the speculative frenzy clouded their judgments.
- Hindsight-biased investors can unduly fault their money managers when funds perform poorly. Looking back at what has occurred in securities markets, these investors perceive every development as inevitable. How, then, could a worthwhile manager be caught by surprise? In fact, even top-quartile managers who implement their strategies correctly may not succeed in every market cycle. Managers of small-cap value funds in the late 1990s, for example, drew a lot of criticism. However, these people weren’t poor managers; their style was simply out of favor at the time.
- Conversely, hindsight bias can cause investors to unduly praise their money managers when funds perform well. The clarity of hindsight obscures the possibility that a manager’s strategy might simply have benefited from good timing or good fortune. Consider the wisdom attributed to managers of aggressive-growth tech funds in the late 1990s.

Mental Accounting Bias

- Mental accounting bias can cause people to imagine that their investments occupy separate “buckets,” or accounts. These categories might include, for example, college fund or money for retirement. Envisioning distinct accounts to correspond with financial goals, however, can cause investors to neglect positions that offset or correlate across accounts. This can lead to suboptimal aggregate portfolio performance.

- Mental accounting bias can cause investors to irrationally distinguish between returns derived from income and those derived from capital appreciation. Many people feel the need to preserve capital (i.e., principal) sums and prefer to spend interest. As a result, some investors chase income streams and can unwittingly erode principal in the process. Consider, for example, a high-income bond fund or a preferred stock that pays a high dividend yet, at times, can suffer a loss of principal due to interest rate fluctuations. Mental accounting can make instruments like these appealing, but they may not benefit the investor in the long run.

- Mental accounting bias can cause investors to allocate assets differently when employer stock is involved. Studies have shown that participants in company retirement plans that offer no company stock as an option tend to invest in a balanced way between equities and fixed-income instruments. However, when employer stock is an option, employees usually allocate a portion of contributions to company stock, with the remainder disbursed evenly over equity and fixed-income investments. Total equity allocation, then, could be too high when company stock was offered, causing these investors’ portfolios to potentially be under diversified. This can be a suboptimal condition because these investors do not fully comprehend the risk that exists in their portfolio.

More on. . .Mental Accounting

- In the same vein as anchoring bias, mental accounting bias can cause investors to succumb to the “house money” effect, wherein risk-taking behavior escalates as wealth grows. Investors exhibiting this rationale behave irrationally because they fail to treat all money as fungible. Biased financial decision making can, of course, endanger a portfolio. (In Research Review we will present some excellent research on the house money effect.)

- Mental accounting bias can cause investors to hesitate to sell investments that once generated significant gains but, over time, have fallen in price. During the bull market of the 2000s, investors became accustomed to healthy, unrealized gains. When most investors had their net worth deflated by the market correction, they hesitated to sell their positions at the then-smaller profit margin. Many today still regret not reaping gains when they could; a number of investments to which people clung following the 1990s boom have become nearly worthless.

Anchoring and Adjustment Bias

- Investors tend to make general market forecasts that are too close to current levels. For example, if the Dow Jones Industrial Aver- age (DJIA) is at 10,500, investors are likely to forecast the index in a way narrower than what might be suggested by historical fluctuation. For example, an investor subject to anchoring might forecast the DJIA to fall between 10,000 and 11,000 at year-end, versus making an absolute estimate based on historical standard deviation (rational) analysis.
- Investors (and securities analysts) tend to stick too closely to their original estimates when new information is learned about a company. For example, if an investor determines that next year's earnings estimate is $2 per share and the company subsequently falters, the investor may not readjust the $2 figure enough to reflect the change because he or she is "anchored" to the $2 figure. This is not limited to downside adjustments—the same phenomenon occurs when companies have upside surprises. (At the end of the chapter, we will review a behaviorally based investment strategy leveraging this concept that has proven to be effective at selecting investments.)
- Investors tend to make a forecast of the percentage that a particular asset class might rise or fall based on the current level of returns. For example, if the DJIA returned 10 percent last year, investors will be anchored on this number when making a forecast about next year.
- Investors can become anchored on the economic states of certain countries or companies. For example, in the 1980s, Japan was an economic powerhouse, and many investors believed that they would remain so for decades. Unfortunately, for some, Japan stagnated for years after the late 1980s. Similarly, IBM was a bellwether stock for decades. Some investors became anchored to the idea that IBM would always be a bellwether. Unfortunately, for some, IBM did not last as a bellwether stock.

FramingBias

- Depending on how questions are asked, framing bias can cause investors to communicate responses to questions about risk tolerance that are either unduly conservative or unduly aggressive. For example, when questions are worded in the “gain” frame, a risk-averse response is more likely. When questions are worded in the “loss” frame, risk-seeking behavior is the likely response.

- The optimistic or pessimistic manner in which an investment or asset allocation recommendation is framed can affect people’s willingness or lack of willingness to invest. Optimistically worded questions are more likely to garner affirmative responses, and optimistically worded answer choices are more likely to be selected than pessimistically phrased alternatives. Framing contexts are often arbitrary and uncorrelated and therefore shouldn’t impact investors’ judgments ... but, they do.

- Narrow framing, a subset of framing bias, can cause even long- term investors to obsess over short-term price fluctuations in a single industry or stock. This behavior works in concert with myopic loss aversion (see Chapter 17): The risk here is that by focusing only on short-term market fluctuations, excessive trading may be the result. This trading behavior has proven to be less than optimal for investors.

- Framing and loss aversion can work together to explain excessive risk aversion. An investor who has incurred a net loss becomes likelier to select a riskier investment, whereas a net gainer feels redisposed toward less risky alternatives.

AvailabilityBias

- Retrievability. Investors will choose investments based on information that is available to them (advertising, suggestions from advisors, friends, etc.) and will not engage in disciplined research or due diligence to verify that the investment selected is a good one.

- Categorization. Investors will choose investments based on categorical lists that they have available in their memory. In their minds, other categories will not be easily recalled and, thus, will be ignored. For example, U.S. investors may ignore countries where potentially rewarding investment opportunities may exist because these countries may not be an easily recalled category in their memory.

- Narrow range of experience. Investors will choose investments that fit their narrow range of life experiences, such as the industry they work in, the region they live in, and the people they associate with. For example, investors who work in the technology industry may believe that only technology investments will be profitable.

- Resonance. Investors will choose investments that resonate with their own personality or that have characteristics that investors can relate to their own behavior. Taking the opposite view, investors ignore potentially good investments because they can't relate to or do not come in contact with characteristics of those investments. For example, thrifty people may not relate to expensive stocks (high price/earnings multiples) and potentially miss out on the benefits of owning these stocks.

Self-Attribution Bias

- Self-attribution investors can, after a period of successful investing (such as one quarter or one year) believe that their success is due to their acumen as investors rather than to factors out of their control. This behavior can lead to taking on too much risk, as the investors become too confident in their behavior.

- Self-attribution bias often leads investors to trade more than is prudent. As investors believe that successful investing (trading) is attributed to skill versus luck, they begin to trade too much, which has been shown to be "hazardous to your wealth."

- Self-attribution bias leads investors to "hear what they want to hear." That is, when investors are presented with information that confirms a decision that they made to make an investment, they will ascribe "brilliance" to themselves. This may lead to investors making a purchase or holding an investment that they should not.

- Self-attribution bias can cause investors to hold underdiversified portfolios, especially among investors that attribute the success of an company's performance to their own contribution, such as corporate executives, board members, and so on. Often, the performance of a stock is not attributed to the skill of an individual person, but rather many factors, including chance; thus, holding a concentrated stock position can be associated with self-attribution and should be avoided.

Recency Bias

- Recency bias can cause investors to extrapolate patterns and make projections based on historical data samples that are too small to ensure accuracy. Investors who forecast future returns based too extensively on only a recent sample of prior returns are vulnerable to purchasing at price peaks. These investors tend to enter asset classes at the wrong times and end up experiencing losses.

- Recency bias can cause investors to ignore fundamental value and to focus only on recent upward price performance. When a return cycle peaks and recent performance figures are most attractive, human nature is to chase promise of a profit. Asset classes can and do become overvalued. By focusing only on price performance and not on valuation, investors risk principal loss when these investments revert to their mean or long-term averages.

- Recency bias can cause investors to utter the words that many market veterans consider the most deceptive and damning of all: "It's different this time." In 1998 and 1999, for example, the short-term memory of recent gains influenced some investors so strongly as to overrule, in their minds, historical facts regarding rational valuations and the bubbles, peaks, and valleys that naturally occur. If your client ever seems to be yielding to this rationale, then it is time for a reality check.

- Recency bias can cause investors to ignore proper asset allocation. Professional investors know the value of proper asset allocation, and they rebalance when necessary in order to maintain proper allocations. Recency bias can cause investors to become infatuated with a given asset class that, for example, appears in vogue. They often concentrate their holdings accordingly. Proper asset allocation is crucial to long-term investment success.

Loss Aversion Bias

- Loss aversion causes investors to hold losing investments too long. This behavior is sometimes described in the context of a debilitating disease: get-even-itis. This is the affliction in which investors hold losing investments in the hope that they get back what they lost. This behavior has seriously negative consequences by depressing portfolio returns.

- Loss aversion can cause investors to sell winners too early, in the fear that their profit will evaporate unless they sell. This behavior limits upside potential of a portfolio, and can lead to too much trading, which has been shown to lower investment returns.

- Loss aversion can cause investors to unknowingly take on more risk in their portfolio than they would if they simply eliminated the investment and moved into a better one (or stayed in cash).

- Loss aversion can cause investors to hold unbalanced portfolios. If, for example, several positions fall in value and the investor is unwilling to sell due to loss aversion, an imbalance can occur. Without proper rebalancing, the allocation is not suited to the long-term goals of the client, leading to suboptimal returns.

Overconfidence Bias

- Overconfident investors overestimate their ability to evaluate a company as a potential investment. As a result, they can become blind to any negative information that might normally indicate a warning sign that either a stock purchase should not take place or a stock that was already purchased should be sold.

- Overconfident investors can trade excessively as a result of believing that they possess special knowledge that others don't have. Excessive trading behavior has proven to lead to poor returns over time.

- Because they don't know, don't understand, or don't heed historical investment performance statistics, overconfident investors can underestimate their downside risks. As a result, they can unexpectedly suffer poor portfolio performance.

- Overconfident investors hold underdiversified portfolios, thereby taking on more risk without a commensurate change in risk tolerance. Often, overconfident investors don't even know that they are accepting more risk than they would normally tolerate.

Self-Control Bias

- Self-control bias can cause investors to spend more today at the expense of saving for tomorrow. This behavior can be hazardous to one's wealth, because retirement can arrive too quickly for investors to have saved enough. Frequently, then, people incur inappropriate degrees of risk in their portfolios in effort to make up for lost time. This can, of course, aggravate the problem.

- Self-control bias may cause investors to fail to plan for retirement. Studies have shown that people who do not plan for retirement are far less likely to retire securely than those who do plan. Studies have shown that people who do not plan for retirement are also less likely to invest in equity securities.

- Self-control bias can cause asset-allocation imbalance problems. For example, some investors may prefer income-producing assets, due to a "spend today" mentality. This behavior can be hazardous to long-term wealth because too many income-producing assets can inhibit a portfolio to keep up with inflation. Other investors might favor different asset classes, such as equities over bonds, simply because they like to take risks and can't control their behavior.

- Self-control bias can cause investors to lose sight of basic financial principles, such as compounding of interest, dollar cost averaging, and similar discipline behaviors that, if adhered to, can help create significant long-term wealth.

Status Quo Bias

- Status quo bias can cause investors, by taking no action, to hold investments inappropriate to their own risk/return profiles. This can mean that investors take excessive risks or invest too conservatively.

- Status quo bias can combine with loss aversion bias. In this scenario, an investor facing an opportunity to reallocate or alter an investment position may choose, instead, to maintain the status quo because the status quo offers the investor a lower probability of realizing a loss. This will be true even if, in the long run, the investor could achieve a higher return by electing an alternative path.

- Status quo bias causes investors to hold securities with which they feel familiar or of which they are emotionally fond. This behavior can compromise financial goals, however, because a subjective comfort level with a security may not justify holding onto it despite poor performance.

- Status quo bias can cause investors to hold securities, either inherited or purchased, because of an aversion to transaction costs associated with selling. This behavior can be hazardous to one's wealth because a commission or a tax is frequently a small price to pay for exiting a poorly performing investment or for properly allocating a portfolio.

Endowment Bias

- Endowment bias influences investors to hold onto securities that they have inherited, regardless of whether retaining those securities is financially wise. This behavior is often the result of the heirs' fear that selling will demonstrate disloyalty to prior generations or will trigger tax consequences.

- Endowment bias causes investors to hold securities they have purchased (already own). This behavior is often the result of decision paralysis, which places an irrational premium on the compensation price demanded in exchange for the disposal of an endowed asset.

- Endowment bias causes investors to hold securities that they have either inherited or purchased because they do not want to incur the transaction costs associated with selling the securities. These costs, however, can be a very small price to pay when evacuating an unwise investment.

- Endowment bias causes investors to hold securities that they have either inherited or purchased because they are familiar with the behavioral characteristics of these endowed investments. Familiarity, though, does not rationally justify retaining a poorly performing stock or bond.

Regret Aversion Bias

- Regret aversion can cause investors to be too conservative in their investment choices. Having suffered losses in the past (i.e., having felt pain of a poor decision regarding a risky investment), many people shy away from making new bold investment decisions and accept only low-risk positions. This behavior can lead to long-term underperformance, and can jeopardize investment goals.

- Regret aversion can cause investors to shy away, unduly, from markets that have recently gone down. Regret-averse individuals fear that if they invest, such a market might subsequently continue its downward trend, prompting them to regret the decision to buy in. Often, however, depressed markets offer bargains, and people can benefit from seizing, decisively, these undervalued investments.

- Regret aversion can cause investors to hold on to losing positions too long. People don't like to admit when they're wrong, and they will go to great lengths to avoid selling (i.e., confronting the reality of) a losing investment. This behavior, similar to loss aversion, is hazardous to one's wealth.

- Regret aversion can cause "herding behavior" because, for some investors, buying into an apparent mass consensus can limit the potential for future regret. The demise of the technology stock bubble of the late 1990s demonstrated that even the most massive herd can stampede in the wrong direction.

More on. . .Regret Aversion

- Regret aversion leads investors to prefer stocks of subjectively designated good companies, even when an alternative stock has an equal or a higher expected return. Regret-averse investors may feel that "riskier" companies require bolder decision making; hence, if the investment fails, the consequences reflect more dramatically on an individual's judgment than do the consequences of investing in a "routine," "safe," or "reliable" stock. With increased perception of personal responsibility, of course, comes increased potential for regret. Investing in good companies may not permit investors any more return or less return than those companies perceived to be risky.

- Regret aversion can cause investors to hold on to winning stocks for too long. People fear that by selling a stock that has been doing well, they might miss out on further imminent gains. The danger here is that in finance, as in physics, whatever goes up must come down.

Affinity Bias

- Investors subject to affinity bias can make investments in companies that make products or deliver services that they like but don’t examine carefully enough the soundness of the investment characteristics of those companies.

- Investors subject to affinity bias can invest in companies that reflect their ESG values but don’t carefully examine the soundness of the investment characteristics of those companies.

- Investors subject to affinity bias can invest in their home countries at the expense of investing in foreign countries due to home country bias.

- Investors subject to affinity bias can sometimes invest in “sophisticated” investment products that convey status only to find they have invested in something they don’t understand, which can be “hazardous to your wealth.”