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GRAY ISSUE
29 August 2019 Issue 216

How bias can sink your investment success

Everybody has biases. We make judgements about people, places, and of course, the markets. It is almost impossible not to allow the filters which are created through our emotions and our experiences to impact our investment decision making. The trick is to understand them, be able to identify them when they occur and to build in steps to mitigate them when needed.

We are presented with a daily barrage of information, from media reports, company statements, market forecasts, expert commentary to banter on social media, that ultimately form the basis of our investment decisions. Making sense of it all can be overwhelming. To facilitate an easier and quicker decision-making process, our brains create cognitive strategies, or shortcuts, called heuristics.

Heuristics in daily life often show up as our "gut feelings" or "common sense". For example, if we are exposed to a lot of footage of, say, plane crashes, we are more likely to overestimate the likelihood of being in one. This is called the availability heuristic: Because the images of a plane crash are easy to recall, our brain makes the connection that they are more likely to occur. Another example is when you like a particular politician or economist, you are less likely to fact-check their statements – this mental shortcut is called the affect heuristic, where your feelings about a thing, person or situation influence your view.

Behavioural biases

While heuristics can help us process information quickly, they can also lead us to make poor decisions, as we rely on intuition rather than carefully weighing up the pros and cons before taking action. Behavioural scientists have studied heuristics and identified numerous biases that can lead us to make poor decisions. These include:

- Availability/attention bias: The tendency to rely on information that comes up frequently, such as extensive media coverage. This bias sees investors gravitate towards familiar company names when looking for an investment, forgetting that companies we hear about less frequently can also be excellent investment opportunities.
- Confirmation bias: The tendency to rely on selective information that supports your belief about an investment. Investors who fall into this trap avoid critical opinions and reports about their chosen investment, cherry-picking information that portrays the investment in a positive light.
- Anchoring: The tendency to rely heavily on one piece of information to make a decision. Human beings love an anchor to cling to, and for many investors, the price you paid for a stock or recent performance can be a psychological anchor. For example, if a sector has achieved impressive returns over the past year, investors will focus on the short-term performance and be tempted to switch their investment to that sector, ignoring long-term performance – as well as their investment strategy. This bias can lead to selling low and buying high, a sure way to destroy value.
- Home bias: The tendency to see investments from one's country as being more trustworthy because you are familiar with the names and products. This bias is one of the reasons investors do not invest enough offshore, missing out on the opportunity to diversify their portfolio to make it less sensitive to local factors.
- Favourite long-shot bias: We are an optimistic species. We always hope for the best, especially in investing. However, this can be a psychological trap. Investors who fall for this bias will frequently buy investments that are a long shot in the hope of high returns, forgetting that the likelihood of the long shot winning is low, and therefore the chances of good returns is also low.

At the recent Allan Gray Investment Summit, renowned psychologist and *New York Times* best-selling author Maria Konnikova discussed three additional biases – the sunk-cost fallacy, the gambler's fallacy and the hot-hand fallacy – that she observed while playing poker professionally. These biases are also present in investing.

Be aware of your bias to make money

Emotions can have a significant impact on your investment success. To make money from investing, investors should learn to manage their behaviour. Key to this is being aware of your own behavioural biases to make better, more rational investment decisions.

A good way to manage your behaviour, especially during market volatility, is to have – and stick to – an investment strategy that is based on your objectives, time horizon and appetite and tolerance for risk. A good independent financial adviser can also help you to remain focused on your strategy and stick to your investment goals when emotions threaten to get the better of you.

To view highlights from the 2019 Allan Gray Investment Summit click here.

Commentary contributed by Tamryn Lamb, head of Retail Distribution, Allan Gray

Additional source: Credit Suisse finance white paper on Behavioural Science: The Psychology of Investing. 2015