Boulder County
Business Report

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Overcome behavioral biases to make rational investments

One of the hardest things to overcome with investing is our behavioral biases. In the 1950s, Harry Markowitz proposed the theory that investors would make rational choices to create efficient portfolios if given the chance and later won the Nobel Prize in 1990 for these theories.

In 2002, psychologist Daniel Kahneman won the Nobel Prize for the work he did with Amos Tversky by showing that investors don't always make the rational choice when investing due to their behavioral biases — the opposite of Markowitz's theory.

These biases lead us to make incorrect decisions — risky or conservative — when it comes to investing. Realizing that you have these biases and overcoming them will help you have a more successful investment experience.

One of the most common biases is called loss aversion. Losses hurt twice as much as gains give us pleasure. So we tend to avoid taking losses and put hope in a possible turn-around that could get us back to even. But taking losses can be more beneficial in some cases. First, losses can reduce our overall tax burden. And second, it frees up money that can be switched to more successful investments.

Another behavioral bias is called endowment. Here we assign greater value to an investment that we already own or inherited. This bias can cloud our judgment when evaluating our portfolio's risk. If you're emotionally tied to an investment, then it would be worthwhile to get a second opinion from someone who doesn't have an emotional attachment to the investment. If you diversify away from the large position, it could lessen the chance of disaster later on.

The anchoring bias leads us to fixate on certain prices or arbitrary numbers such as Dow 10,000 or S&P 500 Index of 1,000. Realizing that these numbers are arbitrary can help us making clearer investment decisions.

GUEST OPINION
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Another bias is called mental accounting where we tend to separate money into different buckets while ignoring the overall allocation of the total pot of money. Realize that even though money can be in different accounts, they could have high correlations to each other and not be very well diversified. It is best to review diversification across all accounts.

The overconfidence bias tends to hit men harder than women. Just because we made one good decision in the past, doesn't mean we'll make all good decisions in the future.

The self-control bias involves too much spending over saving. It's hard to hear from a financial adviser that you need to control spending in order to comfortably retire.

The status quo bias leads one to leave things alone instead of making a change. It feels more comfortable to stay the same. You are afraid that if you make a change that something will go wrong and then your hindsight bias will kick in. This is especially true regarding estate plans. Individuals are very reluctant to update their estate plan even though here are much better alternatives out there.

The regency bias is reinforced by the media. With an event fresh in our minds, we overweight the probability of the same thing happening again because it just happened recently. In other words, we extrapolate the current trend until the end of time.

With the hindsight bias, you tend to look back at events after the fact and deem the events to be obvious after the fact, when really they weren't. They can lead you to take excessive risk without even recognizing that you are taking the extra risk because you have a false sense of security in your decisions.

The framing bias leads one to lean towards a risky outcome or a conservative outcome depending on how the question is framed. If investors are asked to make an investment decision where the emphasis is put on the gain, then they are more likely to go with the riskier alternative and vice versa.

If you have the self attribution bias, you tend to feel your successes are due to your expert knowledge and your failures are due to events beyond your control. Realizing that everyone can't have above average investment success can lead to better outcomes.

Similarly if you have the confirmation bias, you will look for information that validates your investment decision. In addition, you tend to ignore negative information about your decision and this can lead to a larger chance of a bad outcome.

Finally, if you have the familiarity bias you tend invest in things you know about and overweight your familiarity resulting in excessive investment risk. For example, overweighting in your company stock, a local company or a stock you inherited can lead to a lack of diversification and a riskier portfolio.

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