Avoiding Behavioural Biases of Investing

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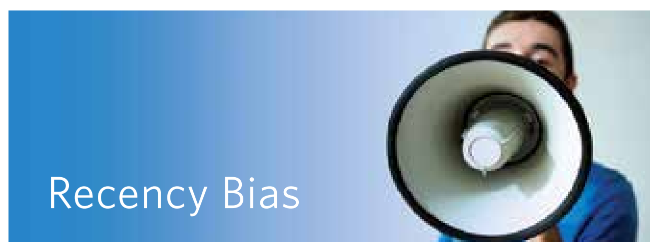
Traditional economic theory puts forward the assumption that all individual investors would behave and act rationally by considering all information available to them. This would be then reflected in the prices of assets and ultimately what makes market efficient.

But we know textbook theories don't apply in real life and investors do not behave rationally all the time. This is particularly true when markets reach euphoric highs or plunge to scary lows. The adrenaline rush kicks-in, the mental circuits around the cerebrum start firing and finally the investors' gut instincts are triggered to prompt them to make the crucial decision whether to buy or sell.

Following these mental cues or tendencies can be harmful especially when logic gets thrown out the window. Decisions that may appear rational are in fact detrimental. To avoid the worst impulses of an investor, it is crucial that one recognises them first and apply clear mental filters to invest with a clear head.

Here are 4 common behavioural biases that can lead investors astray and how one can overcome them.



Recency Bias

Symptom: If you find yourself reacting immediately to every breaking headline and being trigger happy with your investments, you may be succumbing to recency bias which is the tendency to overemphasise new information. In this current 24-hours news cycle with the prevalence of social media, the investment realm has become a global echo chamber constantly reverberating with news alerts.

Ongoing developments surrounding the coronavirus outbreak and the ensuing market correction is a more recent example. But if there is something more contagious than any viral outbreak is the spread of fear; and investors are a fearful bunch. Add to that a web of disinformation and fake news, you have a toxic concoction festering with fear and market angst.

If you look at past outbreaks like that of Severe Acute Respiratory Syndrome (SARS) in 2003, the incident didn't create any long-term impact to asset classes and equity markets promptly recovered after the outbreak was contained.

Having a recency bias will also almost certainly lead you to buy when markets are peaking and selling at the bottom. Investors end up chasing markets and headlines to catch up with performance which is not the ideal formula to invest.

Remedy: There is nothing wrong with staying informed and keeping up-to-date with new information, but the problem lies in how we react. According to Lim Chia Wei, a portfolio manager of Affin Hwang AM, it is important to first recognise that the media thrives by sensationalising new news.

"Personally, I think it is helpful to clearly write down every investment's long-term thesis. As new information presents itself, we should ask ourselves of how the new information will affect our long-term thesis. It is crucial to think in terms of probability. Anything is possible to break or support one's thesis. But not everything is probable," said Chia Wei.

Investors should learn to tune out once a while or even stop constantly checking what the market is up to. The prevalence of market noise as well as the legitimisation of social media as a reliable news source has injected more volatility in markets. Think US President Donald Trump and his penchant for Twitter diplomacy during the ongoing US-China trade talks last year. If you had reacted to every one of the president's tweet, you may find yourself getting burnt in the end by Trump's randomness.

Herding Bias

Symptom: There is safety in numbers correct? Well not really if you look through history. From Tulipmania in the 17th century, the dotcom bubble in the early 2000s as well as the subprime mortgage crisis during the 2008-GFC, history has shown that investors are willing to suspend disbelief when the going gets good. But, we all know how the story ends when there is irrational exuberance bubbling amongst asset classes.

Investors are social creatures after all and we are comforted by the fact that someone else is buying into a particular investment too. But the wisdom of the crowd can be wrong and the repercussions severe. More recent examples like the bitcoin mania underscore the dangers of herding behaviour.

The truth is much of today's market volatility is also fuelled by machines or algo-traders that profit from short-term fluctuation in prices and ignore any fundamental analysis. Behind each market plunge is a digital herd of trading bots programmed to buy and sell based on pre-determined formulas and models. This ignited a 'flash crash' like that seen in 2010 when the Dow Jones Index lost close to 1,000 points in mere minutes. The S&P 500, Dow Jones industrial average and Nasdaq collectively lost $1 trillion. But in 36 minutes, the rout was all over and markets rapidly recouped back its losses.

Remedy: Stop focusing on what the crowd is doing. Instead, work on developing a plan that is right for you. Understanding the self is the first step in modelling a portfolio that is meant to serve your life goals and financial aspirations.

Next, concentrate efforts on building a diversified portfolio that fits your own financial goals and risk-appetite. Intraday fluctuations in markets are unlikely to bother you if you are well diversified across asset classes allowing you to comfortably sit through the turbulence.

A diversified multi-asset portfolio with low correlations helps to smoothen the investment journey when faced with adverse market conditions and tends to reduce jitters in a portfolio. In turn, this would induce investors to stay invested and reap the benefits when markets eventually bounce back.

Loss Aversion Bias

Symptom: We all hate to lose money. But if you find that fear of loss crippling and clouding your decision-making, you may be suffering from loss aversion bias. Investors often feel more acutely the pain of loss than the pleasure they reap from gains. It's the idea that an investor would feel more upset about losing $100 which they own compared to the happiness they receive from making $100 in gains.

Why are we so afraid of loss? It's an emotive response that is typically hard-wired into someone's psyche. It's why we feel more disappointed about our setbacks than the progress we make. In markets, this is manifested through behaviours of extreme risk-avoidance such as investing in only low-risk, low-return investments and selling immediately at the first sign of headwind.

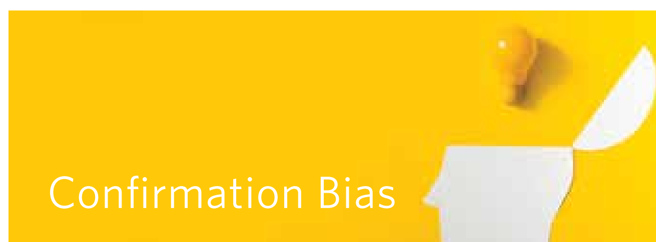
This behaviour is counterproductive to investors' financial goals by not fully utilising their capacity for risk and financial resources. Reacting to every market downturn would also cause investors to materialise losses in their portfolio, forcing them to play catch-up again when markets recover.

Remedy: Investors' memories are by nature short-term and most of the time we only remember the bad parts. Try and adopt a more holistic approach when looking at your portfolio. If you are feeling jittery about markets, consider rebalancing your portfolio to its target asset allocation or locking-in gains to raise some cash.

Importantly, work on developing a financial plan that suits your goals and risk-appetite. Remember that you are supposed to feel comfortable about the level of risk that you are taking with your investments. If you cannot stomach the volatility, chances are that you may be taking too much risk and there is a portfolio mismatch.

Chia Wei believes that it is also important to have the right perspective of performance to overcome one's loss aversion bias. "History has shown that taking a long-term investment approach and sitting through short-term declines has been very rewarding. Investors should push themselves to focus on the long-term prospects and de-emphasise short-term events."

"Even the most horrific past events like world wars, global recessions and global pandemics eventually end and those who remain invested and continued with dollar cost averaging have been well rewarded," continued Chia Wei.



Confirmation Bias

Symptom: One of the more common behavioural biases amongst investors, it stems mainly from overconfidence particularly in bullish market conditions. When investors are misled to think they are invisible in the marketplace when they are raking it in, this can lead something akin to tunnel vision when they only seek out information that supports or confirm their view.

For example, say you just added a new stock into your portfolio. When you continue your research on the stock, you only click on positive headlines which support your decision but avoid negative ones that disprove your thesis about the company.

Restricting yourself to such information only confirms your own assumptions that may lead you to miss important red flags or warning signs. This myopic viewpoint of markets can be perilous to an investor's decision-making process.

Remedy: Be open to new sources of information that may not sit well with you. Ask yourself if the issues raised have their merits and if it would impact the fundamentals of a particular investment you just made. It's not easy to challenge your own assumptions, but it is important to do so especially when there is a lot of hype built-in and technical indicators are pointing to overbought territory.

Providing the fund manager's perspective, Chia Wei believes that it is crucial that one takes a mindful approach. "The most important thing is to be consciously aware of it. With awareness and discipline, one should consistently push themselves to be open-minded to carefully consider opposing views," states Chia Wei.

Investing with Clarity

The first step in overcoming behavioural biases is to understand why we have such tendencies in the first place. But proper planning with clear financial goals can help anchor investors and guide them in their financial journey no matter how markets behave. Stick to a disciplined approach by investing consistently and be conscious about the decisions you make to navigate markets confidently.

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