Investec

The Psychology of Investment

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Advances in the study of behavioural finance have shown that financial institutions may be better at managing money than individual investors. This is mainly because individuals are susceptible to ways of thinking and emotion, which affects the decision-making process. Are these psychological pitfalls avoidable? Are there strategies to block emotion and improve the performance of an individual investor? We find out…

Much like a sporting event or a film, the act of investing invokes emotion. Portfolio management can be dramatic; the ups and downs of the stock market, sudden losses of value, the elation when a fund has trebled in a day, the fury that accompanies a bad decision. An investor's mind is a complex psychological terrain. This has given rise to a new science - behavioural finance.

An individual investor may be perfectly capable of managing money and taking a sophisticated approach to a portfolio. However, there is evidence to show that the same educated investor falls prey to decision biases that impact performance negatively. While classical finance assumes that people are objective and can build rational portfolios to achieve the highest possible return, behavioural finance specialists have spotted a few major flaws in the argument and go on to suggest that decisions are affected by context, emotion and psychological biases that are unavoidable.

The Brain and How it Works

In trying to improve the process of decision making, it is useful to understand the brain. There are two different decision systems in the brain. The first is responsible for providing quick responses experienced at a more "intuitive" level. These intuitive responses are based on habitual behaviour and occur without much thought. They originate from a more primitive part of the brain, responsible for serving our basic survival needs. A good example would be the reaction to a red versus green traffic light. This mode has also been referred to as "heuristic" – that is, people make decisions based on approximate rules of thumb, rather than logic, or thinking about them.

The second decision system is far more "cognitive" because it requires a deeper analysis of all the information before arriving at a conclusion. Not surprisingly, this is much harder work and the decision system resides in the cortex of the brain rather than at a more primitive subcortical level.

Most of our daily decision-making is based on "intuitive reasoning", requiring very little effort, reacting quickly to the information the brain provides. A good illustration of the two systems would be the use of the 'numerical times table' – recalling from memory versus having to work out an answer by long multiplication.

However things change under stressful conditions. In a stressful situation, the intuitive system could go wildly wrong, while the cognitive, logical system processes the information in exactly the same way as before, producing a more accurate response. A stock market crash could induce a reaction that would be very different from the norm.

Because it is more responsive, the intuitive system is susceptible to other powerful influences. At a very fundamental level, human beings experience a degree of "field dependence", where the social setting provides cues to determine behaviour. This is quite important for survival, as it assists in identifying the threats in the environment around us. In fact, 'social pressure' is one of the most powerful determinants of human behaviour, particularly in the highly networked social environments we all belong to, and when market panic occurs, this causes a “herd instinct” in which individuals often abrogate their personal, autonomous rationality, further exacerbating the market effect.

Common Psychological Pitfalls

Cognitive failures, as a result of stress or social pressure can result in a few problems – failure to see the big picture and examining decisions in isolation, using short term decision horizons, buying low and selling high and the overconfidence bias where an investor trades too many times. We take a closer look at some of the biases.

Loss Aversion - Losses are hard to deal with. In a portfolio of stocks, psychologically, losses outweigh gains, and there is a tendency to focus on the loss-makers. Even worse, an investor is more inclined to hold on to the loss making stocks in the hope that luck will change. Loss aversion is a common behaviour pattern in a market downturn and is dangerous as it can prevent investment decisions from being made when they should be. When the much-anticipated recovery never happens, the investor tends to lose more than he/she would have done, had he sold earlier.

Anchoring - best described as an irrational attachment to an investment, specifically to a price, sector, or a piece of information that the investor holds dear. Quite often the investor has a significant 'portfolio experience' that alters his/her perception of a company or a sector. This piece of information firmly lodges in the brain of the investor and is used as evidence to justify other investment decisions. For instance, investors tend to hold on to the purchase price of an asset and use it to compare present values irrespective of the change in the asset over a period of time or of the market. Far too much importance is placed on a minor piece of information.

Recency Bias - is the assumption that a recent set of events or a pattern of events will recur in the future. The recent financial meltdown is a classic example where a majority of the investment world believed that the downturn would repeat itself. Capital was re-allocated and investments had come to a temporary halt. It took a real contrarian investor to take the brave decision to go against market sentiment and go "bottom fishing". Recent memories of loss are a strong guiding force for this type of decision bias. The opposite can be true as well. Investors can allocate cash towards popular funds on the assumption that recent successes will continue when in reality performance of the funds has started to deteriorate.

“Shared Madness” or **Herd Mentality** - People tend to forget that safety in numbers is not safe at all because people in groups act on the basis of crowd behaviour, with emotion prevailing, rather than taking the risk of standing against the powerful effects of the group mind. Shared madness or folie à deux is when social pressure and stress force the brain to abandon the analytical, cognitive approach to decision making.

The stock market is a classic example of how this works. Market behaviour is largely driven by a “herd” impulse – when prices drop, investors panic and sell shares on the assumption that somebody else may have determined a piece of information that is crucial and responsible for the sell-off. Rather than finding out more, following ‘the herd’ is considered the best option. Unfortunately this produces a self-fulfilling momentum in the market and prices drop even further. It takes a very different kind of individual to stand aside from this kind of group behaviour that plays on the intuitive decision system. Warren Buffett is a good example of an investor who has invested against market sentiment. He has the ability to insulate his decisions from fluctuating sentiment and is prepared to hold an investment in the longer term.

Bounded Rationality or Information Bias - Decision-making is also limited by what Herbert A. Simon called “bounded rationality”. This is where decision-making is limited by the information possessed, the cognitive limitations of people’s minds, and the finite amount of time there is for decisions to be made. Given this bounded rationality, most decision-makers opt for decisions that “satisfice”, rather than maximize returns. Information bias also shows up when an investor chooses to stick to investing in sectors he feels comfortable with. Avoiding lesser-known areas could be a safe strategy but only until the investor starts missing out on potentially high returns. Mining and technology are classic examples where investors lack knowledge, are frightened to enter and therefore choose to remain in the conventional retail and banking sectors.

Avoiding Decision Making Biases

The first step to avoid these psychological pitfalls is to become aware of and accept the way the mind works. Educated investors are cautious and careful about succumbing to these common errors.

The next step is instilling a sense of discipline and self-control. Self-control strategies are available in different forms. The most popular ones include setting deadlines, using a cooling-off period before making a decision and setting firm rules. This is obviously better achieved when we subject these decisions, within the context of good governance rules, to a robust dialogue, the way Investec does.

A good way to achieve a better performance may be to delegate the task of managing money to a professional institution. Institutions are aided by strong sets of rules that prevent knee-jerk reactions. The mind may be hard to control but there are ways of avoiding the pitfalls.

There are huge opportunities for individuals and businesses in terms of investment decisions, if an understanding is achieved of how people think in decision-making and we are able to determine the powerful influence of social pressure on our decisions.

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