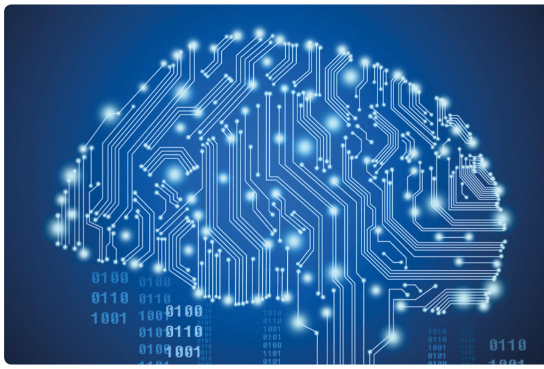
10 investment biases (you didn't know you had)



John Roe, Head of Multi-Asset Funds, takes readers on a whistle-stop tour of 10 behavioural biases that can hinder investment performance.

One of the three key philosophies driving our investment process is our emphasis on disciplined investment thinking. We don't rely on external research or follow the crowd; instead, we have a **25-strong team of experts** that work together within our **structured investment framework** to develop **independent views.**

Why do we think disciplined independent thinking is so important? Like everyone else, investors are susceptible to biases that can influence – and unfortunately undermine – their investment decisions. Increasingly, investors are using this knowledge to design better investment solutions and gain an advantage over the rest of the market.

Here, we identify 10 behavioural biases that we aim to filter out of our investment process.

1 MYOPIC RISK AVERSION

We tend to see the risks we take in isolation, rather than as a series of calls that, collectively, may offer favourable odds over the longer term. As a result, we are tempted to take too little risk. In investment terms, the more frequently you look at your portfolio, the more you may focus on the risks – and in turn, the less likely you are to take them.

2 PROSPECT THEORY

Would you rather win £10m and then lose £9m or win £1m? Objectively there's little difference, but the amount with which investors start out or gain has much more bearing on their behaviour and decisions. The joy of winning the extra £9m is overshadowed by the pain of then losing it. In investment psychology, potential gains and losses are evaluated relative to current capital, and then gains are perceived as being worth less than losses – even those of the same magnitude.

3 FRAMING BIAS

People are influenced by the way in which options are presented to them when making decisions. An option presented as the middle choice among a group of three is most likely to be picked, as is a light colour over a dark one and a star over a triangle. The context in which options are framed fools us all. So when someone extolls a number of 'excellent investment opportunities', they may in fact be driving you towards one in particular.

4 ANCHORING BIAS

In making decisions, people anchor to previous information they have received and then adjust from that point, as it makes getting to a decision easier than starting from scratch. For example if you present an investor with a statistic with a low percentage – say 10% – and then ask them to provide an answer to a completely unrelated question, then even if the correct answer is as high as 90% or 100%, they are likely to provide an artificially low answer. Because they have anchored to the first, unrelated, value you provided. Likewise, if you get a bus with a high or low number on it, you may be excessively positive or negative all day and make erroneous investment decisions accordingly.

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5 AVAILABILITY BIAS

Issues that are widely discussed and information that is more easily available – in other words, material that has more profile, notwithstanding its relevance – will have more influence on decisions. This particularly applies to stories in the news or recent internal discussions. If the prevailing tone in the media or debate is fearful, then that may influence investment decisions.

6 BASE RATE NEGLECT

Ask a room of investment professionals, and 75% may say they are better at investing than average. But only 50% can really be above average. This is known as base rate neglect. In the real world, it means there is a discrepancy between an event – say, a fund manager outperforming – and how likely people assess said event. However, there is usually plenty of quantitative information that can help inform our judgement. Instead of going with a subjective guess of something occurring, it makes more sense to consider the 'base rate' likelihood for similar historic events and then adjust for why the current situation is different.

7 ENDOWMENT EFFECT

If you give someone a gift and ask them to value it, they will generally put a higher price on it than someone who does not own it. It is one of the reasons people tend not to sell their poorly performing investments and begin afresh when evidence suggests it would be prudent to do so. It also means that fund managers are often retained by investors far longer than they objectively should be.

8 STATUS QUO BIAS

Usually, making a new decision seems more painful than doing nothing. From their starting position, investors view anything they lose by selling as a loss and any gains, naturally, as a gain. But because they tend to attach more significance to losses than to gains, the status quo bias is another factor that stops investors from selling.

9 CONFIRMATION BIAS

Once people make a decision, they don't like changing it. We tend to believe we are right, and are overconfident in our choices. As a result, useful new information that doesn't agree with our view will be discounted, while less useful information may be used to justify it. Investors guilty of this may fail to process new information and can miss important new angles.

10 RECENCY BIAS

We're like goldfish, with short memories that emphasise whatever has just happened. So, recent events unduly influence us. In an investment context, people tend to sell after markets fall and buy after markets rise. There is a correlation between the ownership of equities and their recent performance, because people think recent events will continue. But buying at or near the top of the market and selling at or near the bottom? Not a formula for success.

Did you reach the bottom of this list and think you're relatively immune to these biases? Do you think they affect other investors more than you? If so, you may be exhibiting **egocentric bias:** the idea that you're an exception to the rule.

Everyone can fall foul of these behavioural biases. We're all human, after all. But recognising this and making adjustments to your behaviour can help make you a better investor.