DO OUR BIASES AFFECT OUR FINANCIAL CHOICES?

by Dominic Lucente

Even the most seasoned investors are prone to their influence.

Investors are routinely warned about allowing their emotions to influence their decisions. However, they are less routinely cautioned about their preconceptions and biases that may color their financial choices.

In a battle between the facts & biases, our biases may win. If we acknowledge this tendency, we may be able to avoid some unexamined choices when it comes to personal finance. It may actually "pay" to recognize blind spots and biases with investing. Here are some common examples of bias creeping into our financial lives.

Letting emotions run the show. An investor thinks, "I got a great return from that decision," instead of thinking, "that was a good decision because __________."[1]

How many investment decisions do we make that have a predictable outcome? Hardly any. In retrospect, it is all too easy to prize the gain from a decision over the wisdom of the decision, and to, therefore, believe that the findings with the best outcomes were the best decisions (not necessarily true). Putting some distance between your impulse to make a change and the action you want to take to help get some distance from your emotions.[1]

Valuing facts we "know" and "see" more than "abstract" facts. Information that seems abstract may seem less valid or valuable than information that relates to personal experience. This is true when we consider different types of investments, the state of the markets, and the economy's health.[2]

Valuing the latest information most. In the investment world, the latest news is often more valuable than old news. But when the latest news is consistently good (or consistently bad), memories of previous market climate(s) may become too distant. If we are not careful, our minds may subconsciously dismiss the eventual emergence of the next bear (or bull) market.[2]

Being overconfident. The more experienced we are at investing, the more confidence we have about our investment choices. When the market is going up, and a clear majority of our investment choices work out well, this reinforces our confidence, sometimes to a point where we may start to feel we can do little wrong, thanks to the state of the market, our investing acumen, or both. This can be dangerous.[3]

The herd mentality. You know how this goes: if everyone is doing something, they must be doing it for sound and logical reasons. The herd mentality is what leads many investors to buy high (and sell low). It can also promote panic selling. The advent of social media hasn't helped with this idea. Above all, it encourages market timing, and when investors try to time the market, they frequently realize subpar returns.[4]

Sometimes, asking ourselves what our certainty is based on and reflecting about ourselves can be a helpful and informative step. Examining our preconceptions may help us as we invest.

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Citations
1. CNBC.com, September 28, 2020
2. Forbes.com, March 26, 2020
3. Forbes.com, March 19, 2020
4. CNBC.com, June 26, 2020