I’m biased. And so are you…

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The term behavioural finance is all the rage. Behavioural economists have won Nobel Prizes and attract large crowds as key note speakers. A quick google search on behavioural finance will reveal a bewildering array of potential biases.

What is clear is that as normal, emotional human beings (as opposed to the “rational optimisers” that fill the pages of economic textbooks) we all suffer from biases that distract us from making the right decisions. There is a real gap between how we should invest and what we actually do, and this behavioural gap comes at a significant cost.

What is not as clear, is how to identify which biases each of us are most susceptible to - and, importantly, how to address them. While many investors recognise the behavioural biases of others, ironically, they believe they are immune and that it doesn’t really apply to them! We’ve all been guilty of this at some time or other – I know I certainly have.

Below are some of the most common and dangerous biases and ways in which you can assess if you are “at risk”. This will require honestly reflecting on your own historic behaviour and attitudes – but it will be worth it.

Short-term loss aversion

We all like making money more than losing it. That deep, uncomfortable feeling of incurring a loss, especially over a short period (think Steinhoff or ABIL) is enough to send us running for cover. This is true even if the losses are irrelevant in the context of your long-term goal.

How often do you check your portfolio? Daily, weekly, monthly? Those who check more often, are more likely to suffer from this bias, take less risk, trade too much and consequently underperform.

Do you have a stock-broking portfolio or delegate your decision making to a unit trust manager? Those with stock portfolios, have more line items, more flashing numbers on their screens and tend to check their portfolios and trade more often (both to their detriment). The most extreme example of this are day and currency traders, most of whom are now ex traders.

Overconfidence
Being confident is positively correlated to success in life (in fact, it is a vital ingredient in many careers, sports and for entrepreneurs) - but it can be dangerous in investing and shows up through lack of diversification and too much short-term trading.

Spot-test: Relative to your peer group (parents at your school, colleagues at work, fellow students) are you a better investor, driver, parent, lover?

Consistently these tests have shown that, impossibly, more than 50% of any group say "yes".
Do you have any stock that makes up more than 15% or 20% of your portfolio? Many millennials in the US have 90% of their portfolios in a single stock. For some this has worked fabulously but for most this displays overconfidence, is imprudent and potentially disastrous.

If you look at your unit trust portfolio what percentage of funds have been there for more than five years? Industry statistics show that unit trust investors tend to chase top performing funds and invest after they have performed well, disinvesting from poorly performing and out of favour funds. Over time this destroys significant value.

The need for social proof and buying into stories
It feels much more comfortable to do something if others are doing it and is extremely difficult and lonely to swim against the tide. Are you an easily influenced braai or dinner party investor who loves to discuss the latest opportunity and highlight and embellish your recent successes?

Did you buy bitcoin in 2017? Did you talk proudly about it when it was doing well? Perhaps you even started reading books about how to mine it. Did you keep holding it when it collapsed in 2018? Did you still talk as much about it and with the same confidence?
If so, you are more at risk of being sucked into fads, bubbles and ultimately crashes.

Recency bias
We tend to overweight the importance of what is in the news and extrapolate the recent past to determine future outcomes. We feel positive when our portfolios have done well and expect it to continue. Then we feel despondent when they have had a poor run.

How do you feel about SA property stocks? Most investors feel much more negative about SA Property stocks than they did a few years ago when they had done brilliantly and were much more expensive. Have the fundamentals really deteriorated that much or did investors get too optimistic and ignore reality then. Are they over-reacting now?

Similarly, after a spectacular run investing in the dominant technology firms (Facebook, Amazon, Apple, Netflix, Google) became the in vogue, safe bet. In fact, press pundits suggested this was the holy grail and certain investment firms launched niche tech funds and FAANG ETFs, using spectacular historical returns to lure investors.

Successful investing is about assessing both the potential future outcomes (intrinsic value) and the price paid. Overweighting the recent news and performance has rarely been a long-term successful solution.

Have you discovered your bias?
Hopefully these examples helped you identify which biases you are potentially most at-risk of suffering from. The next step is to create a practical framework to address these risks:

• Write down a long-term investment plan that includes your goals, time horizon, rationale for your decisions and how will you act during an inevitable period of sustained market decline. Rehearsing future scenarios can be a very powerful reference tool in times of stress.
• Set a sensible asset allocation aligned to your time-frame and goals and rebalance in a disciplined, structured manner back to target weights. Rebalancing ensures you remain close to your target allocation and enforces an unemotional buy-low, sell-high philosophy.
• Invest regularly and automatically as it reduces the emotional impact (if the market is down, then you are buying more units, if market is up, then your existing portfolio doing well) and commit to increase your contribution annually by at least inflation. It is significantly easier to commit your future self than sacrifice current disposable income.
• Don't check your portfolio too often and don't trade too often. Doing nothing is a much under-rated option and should be your default position. Try to avoid making emotional decisions and if fear or greed is overwhelming your thinking, try to postpone the decision. Once you have a sensible plan, the key is to stick to it.

Behavioural biases are real. And we all suffer from them. Knowing which ones, we are most susceptible to, is the first step to addressing them. Then developing a sensible, practical framework to address these biases can go a long way to improving investor outcomes. Your financial advisor can also help you develop a plan to deal with your particular behavioural bias.