Is the Wool Pulled Over Your Eyes?

Be Wary of These Investor Biases

by Jeffrey Steele

Are you a biased investor? If you are like thousands of other North American investors, you could be. And when it comes to growing the value of your investment portfolio, that's not a good thing. If the best investors are dispassionate and objective, it follows those biased toward one approach or another lack that all-important detachment.

Among the most common investment biases is home country bias, in which investors favor stocks of firms based in their own cities, states, regions or countries. Another is recency bias, where victims fall prey to the conviction the most recent market moves are certain to continue. One more is confirmation bias, which predisposes investors to favor strategies that agree with their own beliefs. A number of other biases exist as well, all demonstrating the ability to pull the wool over the eyes of otherwise smart investors.

All humans are vulnerable to cognitive and functional biases preventing rational decision making in at least some situations.

So said Robert Johnson, CFA, professor of finance at Heider College of Business, Creighton University, Omaha, Nebraska, and CEO and chair of Economic Index Associates, a New York City firm creating investable indexes. Biases aren't always a bad thing, he said. They are sometimes termed "heuristics," meaning mental shortcuts that permit people to make decisions more efficiently and arrive at repeated, complex decisions more quickly. "Such shortcuts have helped us evolve as a species," Johnson continued. "Unfortunately, the very same heuristics that have served us as a species can in an evolutionary sense create barriers to successful investing."

Home Country Bias

Many investors overweight their portfolios with stocks of companies close to home. These may include stocks of their employer, of companies in the industry in which they're employed or organizations based in their cities, states or regions. Often those who succumb to home country bias justify their actions by arguing they know more about these companies than other companies. Therefore, they possess an informational advantage that can spell superior returns. “Even Peter Lynch, the famed manager of Fidelity’s mammoth Magellan Fund from 1977 to 1990, advocated investors should invest in what they know,” Johnson said. Sadly, the evidence points to the contrary.

Investors don’t seem to possess informational advantages about their employers, the industries in which they work or local companies, according to Johnson.

As well, investing in your own employer’s stock or in your employer’s industry might prevent you from the kind of diversification that can insulate you from shocks to your company or industry, potentially resulting in both the loss of your job and losses in your portfolio.

Availability Bias

Beware data you have, but also data you don’t have, said Cindy Huang, CFA, and portfolio manager with Leith Wheeler Investment Counsel, Ltd., in Vancouver, British Columbia.

Amid the plethora of information available to investors today, little is useful, and worse, some can point investors to the wrong conclusion, she said, citing an example from World War II. British engineers assembled a gunfire pattern of bullet holes in World War II fighter planes returning from the front. Based on the patterns, most assumed that additional scarce armor plating was needed where the gunfire was clustered.

“But they would be wrong,” she said, adding the gunfire patterns were on planes that returned. “It was the planes that didn’t return that probably had the best data on them… Don’t let the availability of data fool you into thinking it provides you insight… To combat availability bias, we have to stay vigilant in not letting structural norms like quarterly reporting patterns affect our judgment of a company’s value, a stock’s attractiveness or a manager’s skills. And we need to be vigilant of ourselves. Focus attention on what matters, which is adding value over the long term,” Huang added.

Herd Mentality Bias

Investors hamstrung by herd mentality bias believe a course of action is correct because everyone else is engaging in that action, Huang said. One way to fight this bias is to appoint a devil’s advocate to deliver an outside perspective.

In 2019, Huang and colleagues informed clients Amazon would have to increase sales by 50% every year to justify its stock valuation. The most common 10-year compounded annual growth rate for corporate sales in the U.S. over the previous 70 years was between negative 10% and positive 5%. One or two companies earned an average 10% to 15% annually and no company earned more, she said.

“By actively seeking nonconfirming or opposing views, it can help you ‘disconfirm’ your own views,” Huang said, adding Amazon’s stock price rose 1,762% over the 10 years ending Dec. 31, 2021. As of June 30, 2022, the stock this year had lost more than a third of its value. It was down 36%.

Hindsight Bias

This phenomenon, sometimes nicknamed the “I knew it all along bias,” was initially studied 50 years ago by researchers probing reasons for errors in decision-making. Over confidence in one’s predictions can lead to costly miscues when investing. Many claim to have foreseen the financial crisis that ushered in the Great Recession in 2008. Except that they didn’t, Johnson said, adding most people — from everyday market participants to experts — were caught unaware by the downward slalom. Hindsight bias causes people to view past events as having been predictable.

“After the fact, people see their own predictive abilities in a much more favorable light than they warrant,” he said.

Recency Bias

When investors reach decisions based on events fresh in their minds, counting on those trends to continue, they fall into the trap of recency bias. This can precipitate such rash decisions as acquiring “hot” stocks performing well recently, Huang said. One example was the rush by retail investors into 2021’s Reddit meme stocks, based on speculation and fear of missing out (FOMO). This decision, she said, “produced disastrous results for those who bought into names like AMC Entertainment.” Investors may also reduce their exposure to asset classes that have recently underperformed. Periodic portfolio rebalancing is a way to surmount the hurdle of recency bias. It forces investors to trim winners and add to losers, helping manage the overall risk of the portfolio, Huang said.

Confirmation Bias

As defined, confirmation bias is the tendency of some to seek out, interpret, favor and remember information confirming or reinforcing beliefs the people already possess. This bias is related to several others, including the phenomenon called anchoring, which occurs when we are hesitant to alter our predictions as new information appears.

“Related to confirmation bias is a tendency to focus on and highlight new information that confirms our initial prediction and to dismiss information that contradicts it,” Johnson said. “In fact, we seek information that confirms our position.”

A prime example of confirmation bias is the deeply held conviction by many investors that Elon Musk is a genius unable to do anything wrong. When the belief is contradicted by actions such as Musk’s Twitter transaction, those with confirmation bias reject the evidence of his fallibility because the notion flies in the face of their beliefs, he said.

Disposition Bias

Have you ever known investors who sell high flyers too soon, but hold on to losers too long? Such people are afflicted with disposition or "loss aversion" bias, said Herman Brodie, founder and owners at Prospecta Limited in Birmingham, the United Kingdom. This means that the ancient market adage, "Nobody ever went broke taking a profit," is incorrect. You can go broke taking profits, if you quickly pocket profits on your winning investments, but allow your losers to fester unattended in your portfolio, Brodie remarked.

Added Johnson: "The interesting aspect concerning loss aversion bias is it flies directly in the face of rationality with respect to the U.S. tax code. Investors must pay capital gains taxes on investments sold at a profit, whereas realized investment losses can be used to offset investment gains in computing personal income taxes.

"All things equal, a rational investor should realize losses and let gains ride." He adds that when this bias is taken to the extreme, an investor following this strategy is holding a portfolio of losers.

Overreaction Bias

Anyone who has followed the financial markets for even a modest length of time has witnessed multiple instances of this circumstance. Investors tend to overreact to positive or negative market news, becoming excessively optimistic about well-performing equities and overly gloomy regarding poorly performing stocks.

The focus of research conducted by Werner DeBondt, and Nobel Prize laureate Richard Thaler, overreaction theory holds that investors ultimately realize the error of their ways, adjust their prices and stock prices revert to their rightful valuations.

DeBondt is a professor emeritus at the Driehaus College of Business at DePaul University. Thaler teaches at the University of Chicago Booth School of Business.

Said Johnson: "Overreaction to a firm's unusually good or bad financial situation ultimately leads to a reversal of stock prices in the long run."

> **"Outline your long-term objectives through an Investment Policy Statement."**

Loss Aversion Bias

Investors prefer avoiding losses to acquiring equivalent gains, says Philip Weiss, financial adviser and founder at Apprise Wealth Management in Phoenix, Maryland. In short, losses are much more powerful psychologically than gains.

Selling stocks at a loss means investors have to admit having made a mistake. That's why they avoid it. "One of my favorite lines on loss aversion comes from Philip Fisher, who wrote 'Common Stocks and Uncommon Profits,'" Weiss said. "He wrote, 'More money has probably been lost by investors holding a stock they really did not want until they could "at least come out even" than from any other single reason.'"

Instead of following this fruitless path, investors should remind themselves that money tied up in losing stocks could be redeployed into a potentially better investment, Weiss said. "In addition, if the losing investment is in a taxable account, selling it can also reduce your tax bill," he added. "This…can make recognizing a loss more palatable."

Overcoming Biases

In addition to the tips offered above, are there any overarching strategies investors can pursue to help them sidestep the landmines of investment bias? Yes, experts believe.

The central error underlying the great majority of investing biases is many investors' tendency to focus entirely on the short term. This miscalculation, which is encouraged by the abundance of unhelpful, short-term data available, can afflict companies, asset managers and investors, Huang said.

"Retail investors have a bad habit of attempting to time the market, and/or change managers or strategies at the exact wrong time, which has been proven to result in lagged returns over the long term," she added.

Blocking out the noise, maintaining a long-term perspective and adhering to a road map or outline of your long-term objectives through an Investment Policy Statement (ISP) are all ways to avoid short-termism and its attendant biases, she said.

Johnson also recommends establishing an IPS and adhering to that written document. In clear terms, the IPS sets out an investor's return objectives and risk tolerance over his or her investment time horizon. It also includes applicable constraints, chief among them liquidity needs and tax circumstances. At its core, an IPS sets out the ground rules of the investment process and is the document guiding the investment plan.

The IPS should include a target asset allocation and a glide path for target asset allocation changes over time as the investor gets closer to retirement or investment goals. "All investors should have an IPS, and it's best to develop one in a calmer market," Johnson said.

"Developing an IPS in a volatile market or during major stories is problematic. The whole point of an IPS is to guide you through changing market conditions. It shouldn't be changed as a result of market fluctuations, [only] when your individual circumstances change, perhaps [through] a divorce or other unanticipated life change."

Another strategy to avoid biases is to keep an investment diary, Johnson said, adding doing so is particularly effective in combating hindsight bias. For each buy or sell investment decision, the diary should chronicle three aspects: the investment action, the investment thesis and possible risks.

The diary should be reviewed by the investor who is considering an investment change. "The diary removes our hindsight bias for things that have gone wrong, and our attribution bias for things that have gone right," Johnson concludes. ■