Global Matters Weekly

15 March 2021

Why we are all hard wired to be bad investors

by Gary Moglione

Investing our savings is an extremely important part of life that will have a strong influence on retirement, home ownership and the quality of our lifestyle. Therefore, you would expect us to have evolved to be efficient investors. Unfortunately, we are hard wired to be bad investors as many of our natural instincts force us to fall into a number of behavioural traps that result in poor investment returns.

The first one is herd mentality. This becomes more prevalent at points in the cycle when retail investors are highly active as investment tips get passed on in workplaces, pubs and dinner parties. Everybody has heard stories of people getting rich investing in Bitcoin or technology stocks that has made them motivated to get involved. A small number of high-profile stocks have posted stellar returns in recent years. As a result, valuations have been pushed up ever higher. Higher valuations should spark caution when investing but the reverse actually takes place. People talk about their gains to friends and family sparking more interest in a stock. This causes the share price to rise even further detaching it from intrinsic value. We have witnessed this many times before with the 'nifty fifty' period in the late 1970's and the tech boom in the late 90's. Dare I say we are in a similar environment at the moment.

Another negative behavioural trait is recency bias. This one has been very important in 2020 as a result of the COVID crisis. The global lockdowns created a unique environment of share prices for technology platforms rocketing while those of many businesses that require some form a human contact declined to extreme lows. This was a unique environment but logic tells you that the lockdowns could not be applied forever and historically pandemics, however extreme, eventually dissipate and we return to normality. Rather than taking a long-term view and taking advantage of the low valuations people invested as if the lockdown environment would persist forever. Just months later, as the vaccine rollout moves forward, we are now seeing a reversal of 2020 trend with tech leaders falling and the COVID impaired stocks rallying strongly. By going against their instincts and taking a long term more contrarian view in 2020 investors could have made spectacular returns selling the best performing stocks and buying impaired stocks at incredibly low valuations.

How do we keep these biases out of our decision making when investing? There is no clear answer to this but being conscious of our weaknesses is one step. A robust and well-developed investment process keeps your thinking focussed on the fundamentals. The ability of others on your team to challenge your thesis is also important to remove the blinkers and the potential for confirmation bias (i.e looking for evidence to support your initial instincts in your analysis).

I found that Daniel Kahneman's book "Thinking Fast and Slow" is useful in recognising how your brain makes decisions and how the basics can be applied to investing. The book outlines two types of thinking.

Type 1 – Fast, automatic, frequent, emotional, stereotypic, unconscious

Type 2 – Slow, effortful, infrequent, logical, calculating, conscious

Type 1 thinking is clearly impulsive and emotional. These are two traits that do not work well when investing. Type 1 thinking is used in around 98% of our decision making[1] and does a fine job of both protecting us from danger and allowing us to go about our daily routines. However, type 1 thinking will encourage you to buy high because everyone else is and sell low because the market dislikes the stock, making you fearful of further losses. When thinking about investments it is important to engage your type 2 thinking. Make your decisions slowly and for the long term. Ensure they are backed up with sound and detailed research rather than simply a fear of missing out. Focus on the fundamentals and make your decisions based on logic not emotion. This is not a formula for guaranteed investment success but it will help you to be more self-aware and to avoid some of the behavioural traps we are pre-programmed to fall into.

1 https://suebehaviouraldesign.com/kahneman-fast-slow-thinking/

Belvest 研富