INVESTORS and THEIR DECISIONS - 3

A series of articles, this one being the 3rd, addressing investors and their decisions. In particular, whether other factors than rational considerations play a role in the investment decision process, and if so, what the practical consequences and applications are for investors. The previous article and this one address "Cognitive biases" which may affect investors to make decisions on a non-rational basis.

OVER CONFIDENCE !

THREE MORE COGNITIVE BIASES

In my first article in the series ("Homo Economicus?"), I signalled that the concept of people (read: investors) making decisions rationally has become under fire by a relatively new approach to economic theory: behavioural finance, also referred to as behavioural economics. Behavioural finance identifies many biases. Two types can be recognized: cognitive and emotional biases. This article and the previous one discuss cognitive biases. Cognitive biases affect the way we think and can cloud our judgments.

The three cognitive biases discussed in the last article were:

Anchoring (fixing your mind on a specific number)
Bandwagon (joining the crowd)
Gamblers Fallacy (setting expectations to what is random).

I will now discuss three more:

Over-confidence (excessive confidence in ones own abilities)
Representativeness (making decisions based on stereotypes)
Myopia (short termism)

OVER-CONFIDENCE: EXCESSIVE CONFIDENCE IN ONES OWN ABLITIES

Refers to our boundless ability as human beings to think that we are smarter or more capable than we really are (1) We have too much faith in the precision of our estimates (2).

CLASSICAL EXAMPLE (3) : 82% of people asked (in an experiment) say they are in the top 30% of safe drivers.

When people say (again in an experiment) that they are 90% sure they are right about something, they are actually right 70% of the time.

INVESTOR EXAMPLE I : "I can read markets, trends.., figure out when markets will crash and when they will take off."

INVESTOR EXAMPLE II (4) : "My skills as an investor are better than others"

INVESTOR EXAMPLE III (5) : Tendency to attribute good investment results to one's ability to make the right decisions, and bad results to "the markets".

REPRESENTATIVENESS

When we make decisions based on stereotypes, characterizations that are treated as "representative" of all members of a group. Recognizing an event that is similar to something we have seen elsewhere, and often incorrectly conclude that this event will be the same (6).

CLASSICAL EXAMPLE (7) : When we see a man running out of a bank wearing a ski mask, assuming that he is a bank robber.
Note: what we are doing is using the ski mask and the running to represent the activity of robbing.

INVESTOR EXAMPLE 1 : Treating past performance of e.g. an investment fund as indicative of future results (without looking at any other data).

INVESTOR EXAMPLE 2 (8) : Identifying a significant even such as stock market crash (e.g. Oct 1987, Autumn 2008) as a similar event as the 1929 depression.

MYOPIA (SHORT SIGHTEDNESS)

A tendency in decision makers to focus on information immediately related to their judgment and to ignore other (less prominent) pieces of information (9). The tendency to being overly pre occupied by short term events.

CLASSICAL EXAMPLE (10) : "Tip of the iceberg": when we focus on only the part of something that can be easily observed, but not the rest of it, which is hidden. (Referring to the fact that the majority of an iceberg is below the surface of the water.)
Note: often (mis)used in an alarmist way to strengthen an argument.

INVESTOR EXAMPLE 1 : Short-termism: buying or selling based on an immediate (economic, political) event.

INVESTOR EXAMPLE 2 : "Buying what is hot". Making an investment decision based on the recent (strong performance). Today it would be US Large Cap, a few years ago it was Emerging Markets.

Benjamin Graham, the original value investor, warned against myopia when he famously remarked: "in the short run the market is a voting machine but in the long run it is a weighing machine !" (11)

Our inclination to cognitive biases is also used in marketing, advertising and promotional material to entice us to buy and by the media and news channels to get our attention. So private investors need to be aware of what is coming at them!! This is also where educated financial planners can play a crucial role.

Notes:

(1) From "Psychology and Investing", 25 February 2013, www.morningstar.co.uk
(2) From Investor Behaviour 13.1 www.web-books.com/eLibrary/NC/B0/B65/61MB65.html
(3) See (1)
(4) See (1)
(5) See (2)
(6) From "Rational Investment" www.rtnlblog.net
(7) See 6
(8) From "Heuristics in Investor Decision making", The Journal of Behavioral Finance
(9) From "Psychological myopia: a tendency to think short-sightedly" www.understandinghuman.com
(10) See (9)
(11) From "A long history of myopoc investing" by John Plender, www.FT.com 15 May 2011

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