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What is behavioral finance and how does it affect investing?

The intersection between economics, finance and psychology, known as behavioral finance, has become a major topic of discussion when it comes to investing these days.

Behavioral finance looks at the behavior and personality traits of an individual and studies the links it may have that cause rational people to make irrational financial decisions. In a nutshell, it focuses on the emotions that are involved when an individual makes decisions regarding money and investments. Decisions such as selling a good investment too early in order to feel the gratification of owning a "winner", or holding onto a poor investment for an extended period of time because the investor doesn't want to admit he was wrong (i.e. "it has to come back at some point!").

Unfortunately, the difference between how investors should act and how investors actually make decisions in the real world is often quite the opposite. While many claim to be focused on and say that they are adhering to a well thought-out, long-term strategy for themselves, how they act and react as investors might indicate something completely different.

By understanding some of the areas of behavioral finance, it might help us better recognize our natural biases that could lead us to making illogical and often irrational decisions when it comes to investments and finances.

A good example of this concept is called the prospect theory. The prospect theory is the idea that as humans, the emotional impact from perceived losses is different than that of perceived gains. In other words, our brain reacts more strongly when something that we see as bad occurs compared to something that is good. According to prospect theory, losses for an investor feel at least twice as painful as gains feel rewarding.

Behavioral biases hit us all as investors and can vary depending upon our investor personality type. These biases can be cognitive, illustrated by a tendency to think and act in a certain way, or they can follow a rule of thumb. As mentioned earlier, these biases can cause an individual to have a tendency to take action based on their feelings rather than on the facts.

Here are some common behavioral biases that can affect the financial and investment decisions of an individual investor:

- **Loss Aversion Bias:** This bias occurs when the investor wants to avoid the feeling of regret experienced after making a choice with a negative outcome. Those who are influenced by that feeling of not wanting to take a loss will

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often times take less risk because it lessens the potential for poor outcomes. People find losses from an investment roughly two and a half times as painful as gains are pleasurable,. They don't want to admit the fact that they made a poor investment decision. To avoid the emotional pain of a loss, investors have a strong tendency to hang on to losers (they treat a loss as not real until it's realized).

- **Trend-chasing Bias:** Investors often chase past performance in the mistaken belief that historical returns predict future investment performance. For example, a fund that just had a great year, or a stock that has had a great recent run, can influence investors to pull the trigger based on the assumption that the recent performance will repeat itself in the future. They make this decision with little real research. The same holds true for broader trends, and the desire to chase a popular trend or adapt a "follow the herd mentality" without any deep thought on their own justifying the investment. While some trends tend to persist, others tend to revert to the mean, and there is no way to gauge which is more likely without doing research.

- **Disposition Effect Bias:** This refers to a tendency to label and categorize certain investments as winners or losers. Disposition effect bias can lead an investor to hang onto an investment that no longer has any upside or sell a winning investment too early to make up for previous losses. These types of actions can often times increase capital gains taxes for the investor, while reducing both before and after-tax returns.

- **Hindsight Bias:** Hindsight bias leads an investor to believe after the fact that the onset of a past event was predictable and completely obvious whereas, in fact, the event could not have been reasonably predicted. This can lead an investor to "overestimate" their ability when they have been successful. As such, hindsight can falsely create the belief in the investor that the world is a knowable and controllable place. This unrealistic overconfidence can lead to excessive risk taking when the hindsight creates this illusion of predictive power or ability. This can also lead to paralysis when an investor becomes overwhelmed with doubt for their "dumb" mistakes.

- **Anchoring or Confirmation Bias:** First impressions can be hard to shake because we tend to selectively filter, paying more attention to information that supports our opinions while ignoring the rest. For example, perhaps a stock was bought for $80 is now worth $40. The investor believes that the stock will come back to $80, even though the current stock price of $40 is based on new information about the company and its prospects going forward. He refuses to believe that "he" could have been wrong, and his stubbornness prevents him from wanting to evaluate any new information on the company. Instead, he decides to hold onto the stock because he thinks the stock price will come back. An investor whose thinking is subject to confirmation bias is more likely to look for information that supports or "confirms" his original idea about an investment, rather than seek out information that contradicts it (i.e. proves that he was wrong). If he wouldn't be interested in buying the stock at this new price level, perhaps there are other investments that would make more sense owning?

- **Familiarity Bias:** This occurs when investors have a preference for familiar or well-known investments despite the seemingly obvious gains from diversification. The investor may feel anxiety when diversifying investments between well-known domestic securities and lesser known international securities, as well as between both familiar and unfamiliar stocks and bonds that are outside of his or her comfort zone. This can lead to sub-optimal portfolios and a higher level of risk.

- **Self-attribution Bias:** Investors who suffer from self-attribution bias tend to attribute successful outcomes to their own actions and bad outcomes to external factors. They often exhibit this bias as a means of self-protection or self-enhancement. Investors affected by self-attribution bias may become overconfident. They overestimate their own knowledge and rely too heavily on their intuition. As a result they may make inappropriate choices, investing in things they don't really understand in the mistaken belief that their favorable intuition is enough to justify action.

- **Worry:** The basic act of worrying is a natural human emotion that evokes memories and creates visions of possible future scenarios that can alter an investor's judgment. Anxiety about an investment can increase that investments perceived risk, as well as reduce the investor's risk tolerance level. This will often sway an investor to make "knee-jerk" short-term decisions that detract from the prudent long-term investment strategy.

Avoiding Behavioral Mistakes

Although it is very difficult to completely eliminate the emotional aspects that cause individuals to make irrational decisions, creating a strategic investment plan that is customized to one's situation and personality is one way to reduce the mistakes that can occur due to behavioral biases. Some other best practices that can be helpful include:

- **Knowing your Risk Appetite:** Before setting up an investment plan, a good starting point is to get a solid understanding of one's risk tolerance and comfort level with the volatility in the value of the investment portfolio over time.

- **Understanding your Time Horizon:** Further control the risk in your portfolio by structuring the investment plan so that it addresses both the short-term (i.e. cash, low-risk liquid assets) and long-term needs (i.e. stocks, risk assets).

- **Appropriately Diversify:** Spread out your investment portfolio among different asset classes, particularly those that are low or uncorrelated.

- **Systematic Asset Allocation:** Utilizing investment strategies such as dollar cost averaging to create a systematic plan of attack that takes advantage of market fluctuations, even in a down market period.

- **Always Remember - Past Performance is not indicative of future results:** Although this is not a strategy, realizing that there are many advertisements that focus on a fund or investment's past performance. These are intended to influence the emotions and quite often feed into the "trend-chasing" bias of the investor.

The eventual goal for the individual investor when combating the various aspects of behavioral finance is to obtain peace of mind. By having a thorough understanding of your risk appetite as well as the purpose of each investment in your portfolio, while subsequently sticking to a well-structured customized plan, the investor has a much better chance to feel more confident and less likely to make common behavioral mistakes.

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