Behavioural finance

How human behavioural biases affect investing behaviour

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This guide discusses how human emotions and behaviours can affect investment decisions.

It takes you through the key principles that the study of behavioural finance has revealed, including:

1. How overconfidence can negatively affect investment decisions.

2. How attitudes towards risk and reward can lead to behaviours that can inhibit investing success.

3. How inertia can stop people from saving or making necessary changes to their investments.

4. How taking simplified decision making on complex topics can lead to unexpected investment outcomes.

From reading this guide you will gain an understanding of how to work with your financial adviser to help you overcome your own financial biases.

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What is ‘behavioural finance’?

Most people know that emotions affect investment decisions. People in the world of investments commonly talk about the role greed and fear play in driving stock markets. Behavioural finance extends this analysis to the role of biases in decision making, such as the use of simple rules of thumb for making complex investment decisions. In other words, behavioural finance uses psychology to understand how people make investing decisions.

Human nature usually serves us well in coping with day-to-day life. But it can also get in the way of achieving success in long-term activities, such as saving and investing. There is no ‘cure’ for human nature, but greater awareness of biases can help you, and your adviser, avoid major pitfalls.

How biases affect investing behaviour

Psychological research has documented a range of biases that can affect decision making. Many of these also affect decisions about money and investing.

These biases sit deep within our psyche and as fundamental parts of human nature, they affect all types of investors, both professional and private. Understanding them can help you and your adviser work together to learn to work around them.

Some of the key biases that affect financial decisions include:

- Investing with overconfidence, which can lead to inappropriate or risky investments.
- Investing to avoid loss or regret, at all costs, which can mean we don't invest in way that will truly help us reach our investment objectives.
- Avoiding investing decisions altogether, which can mean we either don't save for the future, or we stick with an inappropriate strategy.
- Avoiding trying to understand complex topics, which can lead us to make uninformed decisions. This can mean we have less chance of meeting investment objectives.

This guide briefly explores how some of these biases work.

The behaviours sit deep within our psyche. They may lead us to unhelpful decisions. As a fundamental part of human nature, these behaviours affect all types of investors, both professional and private. Understanding them can help you and your adviser work together to learn to overcome them.

Overconfidence

Psychology has found that people tend to have unjustified confidence in their abilities and decisions.

Not everyone can be above average

It appears that everyone is susceptible to overconfidence in life and rate themselves much higher than any objective measure would. For example, researchers found that most people rate themselves in the top third of the population in terms of driving ability. This can't be true because, by definition, 50% of drivers are below average. Many studies have also found that overconfidence affects people from all walks of life, such as chief executives, doctors, lawyers and students. All these groups tend to overrate the accuracy of their own ability to predict the future.[1]

Overconfidence is closely related to the human tendency to view the world in positive terms. While this can help you recover from life's disappointments more quickly, it can also become an ongoing source of poor decision making.

1 Barber and Odean (1999), The courage of misguided convictions' Financial Analysts Journal, November/December, p47.

Overconfidence and investing

Overconfidence can cause real problems for investors.

Mistaking luck for skill – When something turns out well after a decision we've made, we claim the credit. However, when something goes badly, we tend to see this as just bad luck or misfortune.

Too much risk – Many investors fall into the trap of believing they can pick winning investments. As a result, they sometimes put too much of their wealth in a single pot, which can be very risky. Research shows that picking winning investments is incredibly hard to do, even for professional investors.

Too much trading – Investors with too much confidence in their skills often buy and sell too often, which can have a negative effect on their returns. Research shows that those who buy and sell often were at a disadvantage compared to those who take a long-term view.

Working with your adviser
Your financial adviser can help you avoid overconfidence and give you an objective perspective on your investment decisions.

Loss aversion

The human tendency to take extreme measures to avoid loss leads to some behaviours that can inhibit investing success.

Attitudes to risk and reward

Financial advisers will normally ask you to complete a questionnaire to establish your attitude to risk. Your tolerance to risk tends to drive the types of investments they recommend for you.

However, the human attitude to risk and reward can be very complex and subtle. It can also change over time and in different circumstances.

For further detail on the nature of investment risk you may wish to refer to our separate investor education guide entitled *Investment risk, Balancing investment risk and potential reward,* available on vanguard.co.uk.

Fear of loss

Behavioural finance suggests investors are more sensitive to loss than to risk and potential return. This means that investors sometimes hold on to losing investments hoping they will recover their losses while quickly selling winners to realise a gain. As a result, investors' 'risk profile' changed depending on whether they are facing a loss or a profit.

In practice, the tendency to sell winning investments and hang on to losing investments has a negative impact on investing returns.

Working with your adviser
Your adviser has a key role in helping you deal with fear of loss and contain your desire to sell winners and hold losing investments. They can help you evaluate whether the investment still has good future prospects and whether it still suits your particular circumstances.

The problem of inertia

Inertia means that people fail to get around to taking action, even on things they want or have agreed to do. Inertia can act as a barrier to effective financial planning, stopping people from saving or making necessary changes to their investments.

Uncertainty and confusion

Confusion about how to proceed lies at the heart of inertia. Uncertainty can lead people to choose the path of least resistance, which is often ‘wait and see’. In this pattern of behaviour, so common in many aspects of our daily lives, the tendency to procrastinate dominates financial decisions.

Overcoming inertia with an autopilot

In recent years behavioural researchers have designed ‘autopilot’ systems to help overcome this bias. For example, many individuals fail to join their company pension plan, probably due to inertia. Automatically enrolling employees in the pension scheme, even when there is a clear chance to opt out, boosts pensions scheme enrolment. In this case, inertia has a positive use.

Autopilot approaches to investing

Autopilot approaches can also have relevance in investing, such as committing to regular monthly investments. Such disciplined approaches can help investors avoid biases like overconfidence and promote more rational behaviour.

Using a set schedule, such as an annual review, to guide decisions can help investors to avoid being swayed by current market conditions, such as the recent performance of a 'hot' investment. Regular investing also helps as the investor tends to accumulate more units or shares of an investment when markets are low than when they are high.

Working with your adviser
Regular investment schemes and automatic investment reviews are approaches that your adviser can help put in place to help you overcome inertia and keep you on track for meeting your investment objectives.

Mental shortcuts

Most people use ‘mental short cuts’ or take very ‘narrow’ views of their investments. This can have a negative impact on investment decisions.

Narrow focus

People tend to focus on the behaviour of individual investments. As a result, investors often overreact when one of those investments goes through a bad patch.

However, when taking a ‘wide’ focus and viewing their portfolio as a whole, can help investors to accept short-term losses in individual securities in the pursuit of their long-term financial goal. This can help avoid making potentially unhelpful short-term investment decisions.

Mental accounting

We often separate our money and financial risk into 'mental accounts' – putting our wealth into various 'buckets'. We often base these pools on a specific goals or time horizon (such as 'retirement', 'school fees' or 'new sports car').

We think very differently about each mental account, investing some in risky assets for gain while treating others more conservatively. This can cause us to focus on the individual buckets rather than thinking broadly, in terms of our entire wealth position.

Working with your adviser
Working with your adviser to understand the human tendency for mental accounting may lead to better investing decisions. Your adviser could focus on your individual mental accounts and perhaps assign individual risk profiles and objectives to each account. They can also help you to evaluate your financial standing and avoid focusing too much on individual investments.

Using investing shortcuts

Your adviser understands the importance of holding a mix of investments in proportions that reflect your particular circumstances. However, behavioural finance suggests investors struggle to apply the concept in practice.

Simplistic 'rules of thumb'

Evidence suggests that investors use simplistic 'rules of thumb' when structuring their investments. For example, they might invest equal amounts in a number of different investments in equal proportion, ignoring the risk-return profile of each and the relationships between them.

Investors might understand the importance of holding a broad mix of investments, but not knowing exactly how to go about it, they go for a simple approach. This can lead to a mix of investments that may not match the investor's actual risk tolerance or ultimately meet their investment objective.

Investing in the familiar

People tend to like to invest in things that are familiar. They associate investments that they know about with low risk. So, for example, investors in the UK might tend to prefer to invest in UK companies. The danger with this approach is that your portfolio may not be diverse enough to help offset falls in any one type of investment or market.

For example, in the UK in recent years, the familiarity of property may have caused many investors to underestimate the risks involved, although recent market falls may have changed this perspective.

Working with your adviser
Your adviser can help you achieve a broad mix of investments and avoid concentrating risk in particular investments. They can help you understand why familiarity is not a substitute for a good spread of investments.

The misuse of information

Behavioural finance identifies the ways we tend to filter out and misuse information when investing. We tend to apply simplified decision-making strategies to complex situations. Sometimes these strategies are helpful, but in some cases they can mislead us.

Information ‘anchors’

Decisions can be ‘anchored’ by the way information is presented. For example, large round numbers can act as anchors for investing. Numbers, such as 5,000 points on the FTSE 100, seem to attract disproportionate interest, despite just being numbers like any other.

Recent events

Some evidence suggests that recently observed or experienced events strongly influence decisions. For example, people tend to feel they have a greater chance of having a car crash if they’ve seen one recently. The recent memory makes the prospect more vivid, and therefore seem more likely.

To give a financial example, investors are more likely to be fearful of a stock market crash when one has occurred in the recent past.

Superficial decision making

Sometimes we make decisions based on a situation's superficial characteristics (what it looks like) rather than a detailed evaluation of the reality. Another way of putting this would be saying that decisions are made based on stereotypes. A common financial example would be assuming that the past performance of an investment is an indication of its future performance, when in fact past performance should never be relied upon as an indicator of future returns.

People also tend to look at short-term investment performance and believe it will continue, rather than take a longer term view.

Conservatism

People often take a very conservative approach to changing their minds after taking a decision, despite new contradictory information. For example, investors who invest in a high-profile company may be slow to adjust their view of the company's prospects even after the company's profitability declines.

Working with your adviser
Advisers can help you avoid misusing or simplifying information by putting it in context. Some advisers use checklists to help identify these types of potential investment pitfalls.

What next?

This guide has described behavioural finance and what it means for you as you work with your adviser to create a plan that will help you reach your financial goals.

We've discussed a range of deep-seated human behaviours, which tend to detract from investment success.

With this knowledge you should be better prepared to work with your financial adviser when constructing a long-term investment plan with a better chance of meeting your investment goals.

Bibliography and further reading

If you want to explore behavioural finance in more detail you might find the following books of interest.

For a more detailed but accessible introduction to behavioural finance try:

Shefrin, Hersh, 2000. *Beyond Greed and Fear: Finance and the Psychology of Investing.*

For a more general discussion of the role of behavioural economics consider:

Thaler, Richard and Sunstein, Cass, 2008. *Nudge: Improving Decisions about Health, Wealth and Happiness.*

For a fascinating review of the recent research from the emerging field of neuroeconomics, read:

Zweig, Jason, 2007. *Your money and your brain.*

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