The Psychology of Investing

Conversations about investing usually revolve around financial topics. Corporate earnings, interest rates, commodity prices and the financial impact of geopolitical events are all viewed as having a significant impact on the success or failure of an individual's investment strategy. The truth is, however, that the financial aspects of a successful investment strategy are relatively straightforward. If you diversify, keep costs low and recognize that markets are unpredictable, you will most likely have a very successful long-term investment experience, as long as you have the *psychological discipline* to maintain your strategy throughout an investing lifetime.

The "psychological discipline" part is where the difficulty arises for most investors. Even if you have a simple and financially sound investment strategy in place, you will not be a successful investor if your own human psychology causes you to make poor decisions.

The fact is that individuals tend to make most decisions, and especially financial decisions, based upon emotions rather than reason. It is therefore important to understand how human psychology influences financial decisions and how those influences can affect investment outcomes. We all know that fear, greed and regret play a major part in investor behavior. However, the field of behavioral finance has identified some more complex psychological biases that affect our behavior as well:

Overconfidence: It is an observed fact that most people are overconfident in their own abilities. This self-centered optimism serves us well in athletics, entrepreneurial activities, politics and life in general, but it is a hindrance to success in the investment markets. An individual investor who believes that she is more knowledgeable than the market as a whole is setting herself up for disappointment.

Activity Bias: This is the human tendency to always want to be active, especially in times of stress. This natural drive allows us to achieve our goals and to avoid danger, but it is usually counter-productive in an investment context. Because markets are unpredictable by nature, investors are best-served by an investment approach that involves a disciplined *inactivity* in volatile times.

Trend-following / Representativeness: Humans have a well-developed ability to see patterns in nature. This ability causes us to create stereotypes and to believe that the past, and especially the recent past, is indicative of what the future will bring. However, financial markets do not operate the way nature does. In the short-term, markets move in a random fashion and the recent past offers little (if any) insight into the future movement of the markets.

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Herding: We are all mammals, and mammals often exhibit group behavior. Like the activity bias, the herding instinct has been a helpful survival trait in human evolution, but it offers no assistance to investors. Buying just because everyone seems to be getting rich, or selling when everyone is in a panic can lead to a disastrous investment outcome.

Familiarity Bias: This is the tendency to gravitate towards the things that you are most familiar with. Familiarity bias can encourage you to under-diversify by only buying stock in companies that employ your family members or that make products you use. It can also cause you to avoid diversifying outside your home country. The "buy what you know" strategy may feel good, but it will give you a concentrated, high-risk portfolio instead of a diversified one.

Loss Aversion: This is perhaps the most peculiar of the psychological biases. Numerous studies have shown that humans will have a far greater emotional reaction to a financial loss than to a financial gain of the same amount. Loss aversion can cause an investor to become too conservative after a difficult period in the markets or to avoid selling a poor investment for fear of realizing a loss.

In the coming months we will publish a series of articles which will focus on some of these behavioral biases in more detail. These biases are an integral part of human nature and cannot be removed from the human psyche. Our goal is therefore not to eliminate these biases, but to make you more aware of them so that you can account for their presence when making financial decisions, and to encourage you to work with an advisor who is aware of these biases in your psychology and his own.

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