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Human Biases in investing and how to overcome them

"The four most dangerous words in investing are: 'This. Time. It's. Different!'" – Sir John Templeton

The market euphoria today, makes me wonder whether we have reached a stage where the difference between good, bad and ugly is slowly diminishing.

The word, 'Common Sense' too in Howard Marks' (Famous American investor and writer) memo, titled 'Everyone Knows', is positioned as an oxymoron- A figure of speech with two opposite ideas.

Speaking of ideas, I feel the inference of an idea is subjective. What everyone believes to be a great one may not be that great.

For e.g. If all believe that X investment is a really good proposition and buy it, then suddenly the consensus changes; everyone invests in it and then becomes a seller. Thus, there are no buyers left to invest in that investment. This can be a very dangerous situation. Even if the consensus doesn't change over a longer period, because of over researching, there might not be any bargain left for the investor for future returns. Hence, allocation to consensus might not be the best idea.

Investing in my opinion is more of emotions and less of finance.

Counterintuitive as it may sound, the fact of the matter is that we all have certain biases and experientials. Everyone has access to the same kind of information; the trick lies in how each one reacts to that piece. This phenomenon results in market inefficiency. (Proponents of Market Theory also believe that, the price of an asset is a true reflection of all the information available about the asset.)

The objective of this article is to identify the common biases and benefit from these market inefficiencies, rather than becoming a prey to them.

1) **Herding:**
We all believe that our safety net is when we are a part of the herd. We tend to be bullish when the market is bullish and vice versa. Looking at the majority, be it institutional or retail, we make our judgements basis the same herd. As mentioned earlier, what's good today might not be a good bargain tomorrow or worse, if it fails, it will fail significantly faster than the others. Herding also works in fund selection, where we essentially keep investing more in the best performing fund in the last one, three or five year period because it's popular.

2) **Recency Bias:**
We are all prone to this; we extrapolate current events into the future indefinitely. We expect the same results without considering the fact that the other elements of the market are quite dynamic. For example, when equity markets do well, people tend to go overweight on equity, assuming that the same performance will continue in the future. Changing asset allocation decisions based on recent out performance often leads to disproportionate portfolio allocation.

3) **Affinity:**

Our own likes and dislikes, opinions and feelings heavily influence our decision making process. No wonder you'll find a lot of IT stocks in the portfolio of an IT professional, Pharma stocks in a doctor's portfolio, etc. We might be inclined towards a particular field however that doesn't make it a better investment. Sometimes affinity can cause behaviour to move huge standard deviations away from the normal.

4) **Anchoring and Hind sight bias:**

Everything seems crystal clear in hindsight. How many times do we hear that because an event occurred in the past and markets behaved in a particular fashion, same would hold true all the time? Example of anchoring is what we see in most equity analyst presentations; the target price of the stocks is set very close to the current price (10-15%- give and take). However, businesses don't grow or decline at the same rate, and hence this brings in inefficiencies.

5) **Choice paralysis:**

Counterintuitive to what we believe, the more choices we have, the worse we get at making decisions. This leads to choice paralysis. As per a study, an adult brain makes about 35,000 decisions in a day. People tend to wait indefinitely before making a decision when there are too many choices, as the brain can't process this amount of information. Having too many advisors who have absolutely diverse opinions actually make the matters worse.

6) **Loss aversion:**

We are very averse to loss-making. We are affected by loss 2 to 2.5 times stronger than our gains. This leads to investors flocking in safe assets. We tend to make bold predictions about the power of equity as an asset class in the portfolio, however our portfolios don't seem to reflect the same optimism.

How to overcome these biases:

The only way to deal with biases is to acknowledge them. People suffer from what psychologists call the 'Bias Blind Spot', wherein we don't want to acknowledge that there is a bias creeping in to our decision-making process. Recognizing the 'bias element' can be done through discussions with people who have diverse views. Once these are identified and ranked in order of impact, the highest weight bias in decision-making should be dealt with first. This transformation takes time and is not as easy as it sounds. However, it can be achieved with a little bit of practice. That's why one should always have an advisor who helps in making the right decision. Benjamin Graham, the father of value investing, very rightly said: “The investor's chief problem – and even his worst enemy – is likely to be himself.”

Now's the time for us to acknowledge this.