Beware of Bias when Making Financial Decisions
Pt.1

\\Trinidad and Tobago Securities and Exchange Commission

When we think of finance, many of us immediately think of complex equations, algorithms or charts. Indeed, numbers do play an important role in the finance industry but an often overlooked, and just as important, aspect is the role of behavioural psychology. In this week's article the focus will be on the psychological aspect of the financial decision-making process, otherwise known as bias, and how some commonly exhibited biases can affect one's judgment in making appropriate financial decisions.

What is Bias and Why is it Dangerous?

According to investopedia.com, bias *"is an illogical or irrational preference or prejudice held by an individual, which may also be subconscious."* As human beings, we are all subject to our own biases in all areas of our lives – personally, professionally and even financially. In this article, we will look at how these biases affect the financial aspects of our lives and how you can make wiser financial decisions by keeping these biases in check.

Biases are dangerous because they make sub-optimal, and even terrible, financial decisions seem justifiable, which can result in inferior financial performance. While it is practically impossible to remove bias altogether from our decisions, we can minimise its effects by first becoming aware of it and then looking for alternative and/or additional reasons to base our financial decisions.

In psychology, biases can be categorised into a myriad of broad, non-mutually exclusive groups. However, for simplicity, we can categorise biases into two (2) main types – cognitive and emotional.

COGNITIVE BIASES

Cognitive biases occur when people process and interpret information in a systematically incorrect way. These biases may be related to the person's ability to recall past information, the way the information is presented to them, or the level of attention or emphasis they pay to select pieces of information. We will look more in detail at two (2) types of cognitive biases – anchoring and confirmation biases.

Anchoring

Anchoring bias is the tendency for persons to place undue emphasis on the first piece of information (e.g., price) that he/she is exposed to on a particular product. For example, you may purchase stock in a company at a certain price today and remain psychologically fixated on that price when making decisions on a future sale or purchase of that same stock.

Decisions to sell the stock solely based on the price being higher than the acquisition price – an intrinsically irrelevant data point – ignores any future prospects based on the company's fundamentals. It is indeed important to keep track of percentage gains or losses of one's investment portfolio, but one should be mindful not to completely base one's financial decisions on arbitrary anchors, such as purchase price or historical averages.

Confirmation

In many instances, when doing research on a security, investors may be presented with conflicting information which obscure the investment decision to buy, hold or sell. What is important though is that we keep our biases in check when conducting our research. One such bias being confirmation bias – the tendency for persons to favor information that confirms their existing beliefs.

Suppose a company that you have held in your portfolio for a long time has a surge in profit margin or is in the process of launching a new product. It is easy for these favorable indicators to 'confirm' your decision to hold, or even invest more in securities of that company. It is important though not to let these attractive features blind you from any negative news or red flags that may hinder the company's performance. It may be wise to be more skeptical of your initial conclusion – ask yourself questions such as whether the company has undertaken greater leverage or risk to achieve this greater performance or whether the source of the company's revenue is sustainable in the medium to long term.

EMOTIONAL BIASES

Emotional biases on the other hand relate to how people feel as opposed to how they process information. These types of biases are not necessarily 'errors' but rather ways of thinking that may be deeply rooted in personal experiences that influence a person's decision-making and asset allocation. We will have a more detailed look at two (2) types of emotional biases; specifically, regret-aversion and endowment biases.

Regret-Aversion

You have probably heard the term 'FOMO' (Fear of Missing Out), especially in conversations about the latest Ponzi, Pyramid or Multi-Level Marketing Schemes. FOMO though is only a subsection of the larger psychological phenomena known as Regret-Aversion Bias – the tendency for people to make decisions to avoid the pain associated with regret of not making said decision.

Regret-Aversion bias can exist in two (2) ways – taking action to avoid consequences of inaction (errors of omission) or not taking action to avoid consequences of action (errors of commission). For example, we may be tempted to invest in the latest Initial Public Offering (IPO) out of fear that we may not be able to purchase that security at that price in the future. Conversely, we may be reluctant to divest from a poorly performing position solely out of fear that the security will rise in value and recover in the near future. These decisions are based on fear (rather than the actual characteristics of the investment) and are likely to lead to sub-optimal portfolio performance.

Endowment

Endowment bias occurs when people place a higher value on something they already own, compared to the hypothetical value they would have placed on that same item if they did not own it. This is because persons tend to become emotionally attached to things they own or have rights to. Endowment bias is very much present in wealth management and can best be seen when individuals inherit concentrated positions in one or a few assets, whether it be company shares, luxury vehicles, a private business or real estate.

It is common for beneficiaries of estates to be emotionally attached to the belongings of the past generation and be reluctant to liquidate their positions or expect exorbitant sums for assets which they themselves would not pay. Put another way, if the cash equivalent of the asset was bequeathed as opposed to the item itself, it is unlikely that the beneficiary would then use it to purchase said asset, but rather opt for a more diversified allocation. It is important to keep endowment bias in check as it can result in a poorly constructed asset base with concentrated positions in underperforming or even unnecessary assets.

If you are uncertain, or simply lack the knowledge, on how to choose an appropriate investment, you are not alone. These decisions are certainly challenging to make, and biases only makes this process even more difficult. Please ensure that you consult with a registered Investment Adviser or Broker-Dealer who is qualified in assisting persons make these important decisions, and remember… *Beware of Bias! Visit www.ttsec.org.tt for a list of registered investment advisers and broker-dealers.* Next week, we will look at some more types of biases and ways financial advisors may treat with clients who exhibit different types of biases.

For more information on the securities market and the role and functions of the TTSEC, please visit our corporate website at www.ttsec.org.tt. To become a smart investor, download our Investor Protection App via the Google Play and Apple Stores. You can also take the investor education online course on our investor education website, www.InvestUcateTT.com, and test your knowledge in our interactive investing game InvestorQuestTT at www.InvestorQuest-tt.com, and remember, to connect with us via Facebook; Twitter, Instagram, LinkedIn or You Tube.

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