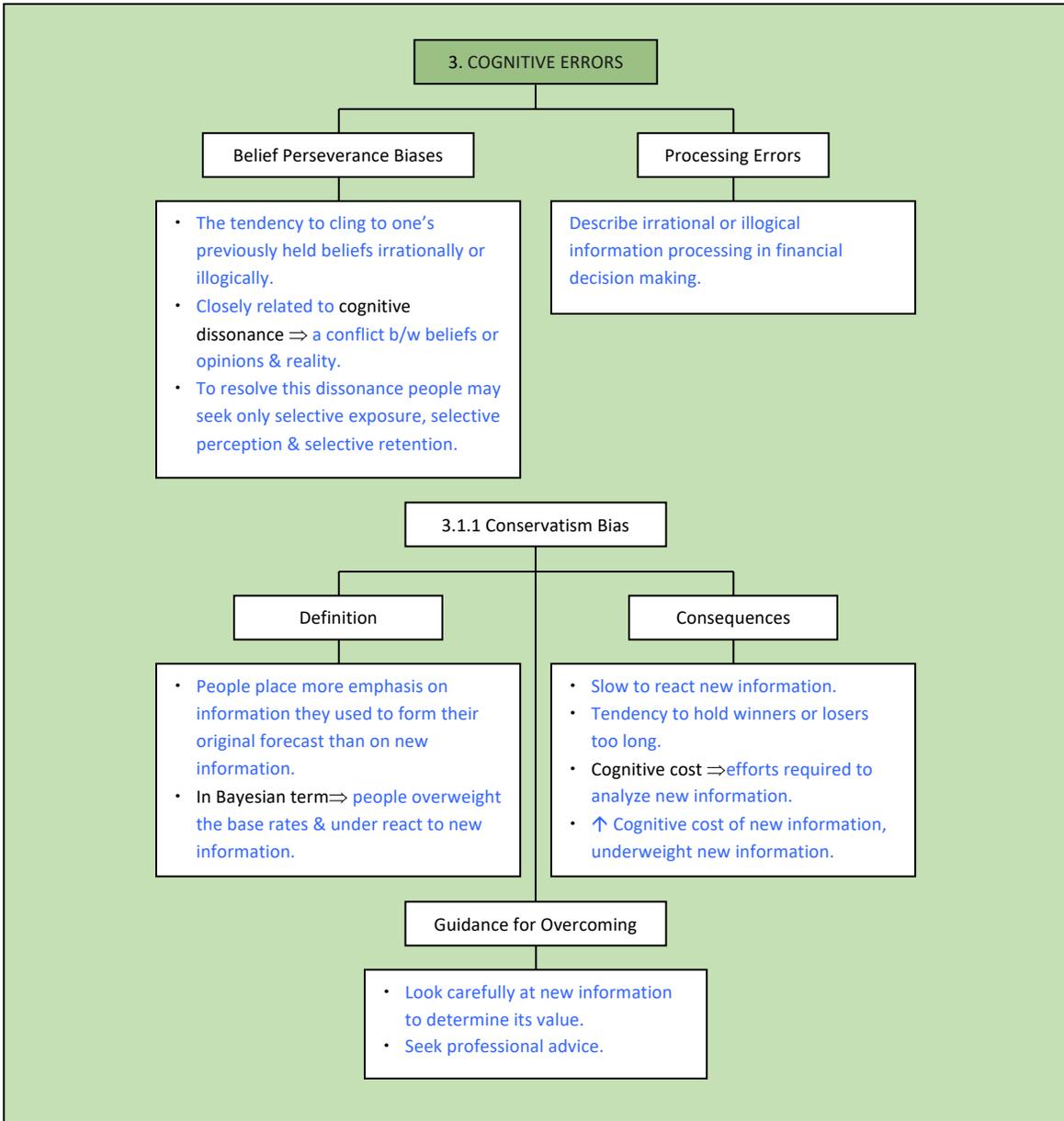
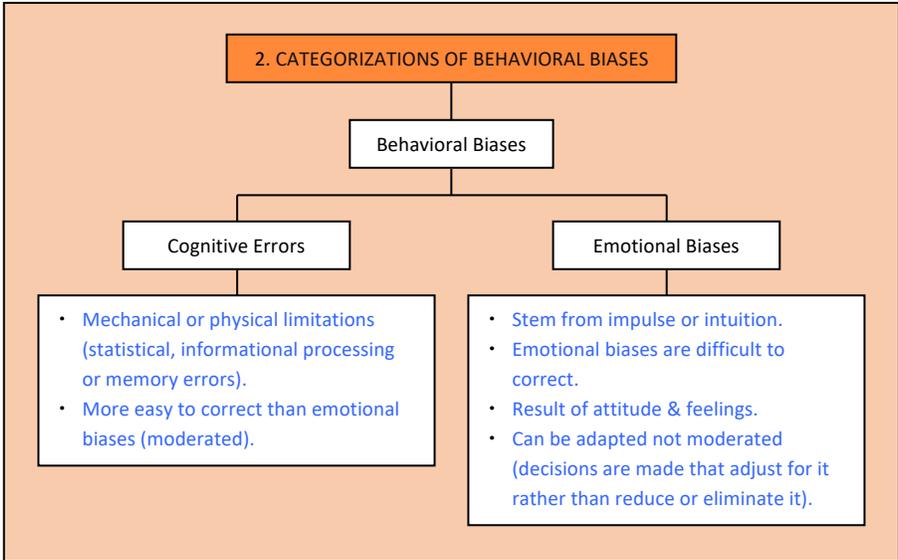


The Behavioral Biases of Individuals

FMP= Financial Market Participants



3.1.2 Confirmation Bias

Definition

- People tend to look for & notice what confirms their beliefs & undervalue the contradict views.
- It is a natural response to cognitive dissonance.

Consequences

- Consider only the +ve information & ignore -ve information.
- May be incorrect screening criteria.
- Under-diversified portfolios.
- Employees may overweight employer's stocks.

Guidance for Overcoming

- One should seek out information that challenges one's beliefs.
- Get corroborating support.
- Do additional research.

3.1.3 Representativeness Bias

Definition

- If-then heuristic where individuals classify information into subjective categories using heuristics.
- In Bayesian terms, investors tend to underweight the base rates & overweight the new information.

Types

i) Base-Rate Neglect

- Too little weight to the base rate

ii) Sample Size Neglect

- Incorrect assumption ⇒ small sample sizes are representative of population.
- Too much weight to new information.

Consequences

- Emphasis is on new information.
- Use simple classification rather than deal with the mental stress of updating beliefs given complex data (low cognitive cost).

Guidance for Overcoming

- Under reliance on recent performance that results in excessive trading & ↓ return.
- Use a periodic table of investment returns that ensure diversification over return chasing.

3.1.4 Illusion of Control Bias

Definition

- Bias in which people tend to believe that they can control outcomes, when in fact they can't.
- Subjective probability of personal success is ↑.

Consequences

- Excessive trading & inferior performance.
- Less diversified portfolio.

Guidance for Overcoming

- Investors should recognize that investing is a probabilistic activity.
- Seek contrary viewpoints.
- Keep records including reminders outlining the rationale behind each trade.

