The Behavioral Biases of Individuals

FMP= Financial Market Participants

2. CATEGORIZATIONS OF BEHAVIORAL BIASES

Behavioral Biases

Cognitive Errors

- Mechanical or physical limitations (statistical, informational processing or memory errors).
- More easy to correct than emotional biases (moderated).

Emotional Biases

- Stem from impulse or intuition.
- Emotional biases are difficult to correct.
- Result of attitude & feelings.
- Can be adapted not moderated (decisions are made that adjust for it rather than reduce or eliminate it).

3. COGNITIVE ERRORS

Belief Perseverance Biases

- The tendency to cling to one's previously held beliefs irrationally or illogically.
- Closely related to cognitive dissonance ⇒ a conflict b/w beliefs or opinions & reality.
- To resolve this dissonance people may seek only selective exposure, selective perception & selective retention.

Processing Errors

Describe irrational or illogical information processing in financial decision making.

3.1.1 Conservatism Bias

Definition

- People place more emphasis on information they used to form their original forecast than on new information.
- In Bayesian term⇒ people overweight the base rates & under react to new information.

Consequences

- Slow to react new information.
- Tendency to hold winners or losers too long.
- Cognitive cost ⇒efforts required to analyze new information.
- ↑ Cognitive cost of new information, underweight new information.

Guidance for Overcoming

- Look carefully at new information to determine its value.
- Seek professional advice.

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 infact 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.

3.1.5 Hindsight Bias

Definition
- Individuals perceive outcomes (past events) as reasonable & expected.
- People overweigh their predictions because they are biased by the knowledge of what actually happened.

Consequences
- Excessive risk because of false sense of confidence.
- Unfair assessment of money managers & security performance.

Guidance for Overcoming
- Carefully record & examine investment decision.
- Markets move in cycles so expectations must be managed.
- Investment managers must be evaluated relative to appropriate benchmarks.

3.2 Information-Processing Biases

3.2.1 Anchoring and Adjustment Bias

Definition
- Individual seem to be anchored to a value or number & then adjust the number to reflect new information.

Consequences
Investors tend to remain focused on & stay close to their original forecasts.

Guidance for Overcoming
- Less weight to historical information.
- Look at the basis for any recommendations.

3.2.2 Mental Accounting Bias

Definition
- Individual place each goal & the wealth, that will be used to meet each goal, into a separate mental account.

Consequences
- Layered pyramid format portfolios ignoring correlations among assets.
- Consider income & capital gains separately.
- Too much risk in search of ↑ potential current income.

Guidance for Overcoming
- Create a portfolio strategy taking all assets into consideration.
- Total return consideration.

3.2.3 Framing Bias

Definition
- Bias in which a person answers a question differently based on the way in which it is asked.
- Narrow framing ⇒ investors use too narrow a frame of reference.

Consequences
- More risk averse when presented with a gain frame & more risk seeking when presented with a loss frame (sub optimal portfolios).
- Excessive trading.

Guidance for Overcoming
- Investors should focus on expected return & risk rather than on gain or losses.
- When interpreting investment situations, investor should be neutral & open minded.