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Psychological investment traps in a market crisis

Seven common behavioural biases to avoid

Sabil Chowdhury

In finance textbooks, academics assume that investors act rationally when making investment decisions. However, in practice, investors are not fully rational. This is especially true during market crises such as the severe volatility and uncertainty brought on by the coronavirus (COVID-19) pandemic. At times of distress and uncertainty, investors are subject to psychological biases when making investment decisions.

Regardless of how disciplined they are, people invest with innate behavioural biases that cause them to act on emotion rather than based on facts. This is the basis of behavioural finance, a field of study that combines psychological theory with conventional economics. This paper discusses several psychological traps that investors should avoid during a market crisis.

1. Overconfidence

Studies show that overconfident investors trade more frequently and fail to appropriately diversify their portfolio. To counter an overconfident mindset, investors should consider trading less and investing more. By entering into trading activities, investors are trading against computers, institutional investors, fund managers and others around the world who can have far better data and more experience.

By increasing their timeframe and holding a diversified portfolio with exposures to different asset classes that are uncorrelated, investors are more likely to consistently build wealth over time. They would be well advised to resist the urge to believe that their information and intuition is better than others in the market.

Overconfidence leads to the unfounded belief that the investor possesses superior stock-picking abilities when they in fact do not.

Example 1. 'Unlikely' occurrences

Many stock-pickers have been caught out during COVID-19 by investing into companies they believed would recover but unfortunately did not, such as Virgin Airlines.

2. Confirmation bias

Confirmation bias suggests that an investor would be more likely to look for information that supports their original idea about an investment rather than seek out information that contradicts it.

As a result, this bias can often result in irrational decision-making because one-sided information tends to skew an investor's frame of reference, leaving them with an incomplete picture of the situation.

Example 2. Reinforcement: a stuck record

Confirmation bias develops when a person reads selected material about a topic that backs up their viewpoint and they subsequently keep on being exposed to the same argument to confirm their initial opinion without considering other contrary views.

Consider

One solution to overcome confirmation bias is to stress test one's ideas by asking other people about their opinions and being open-minded to other viewpoints to develop a more balanced perspective.

3. Hindsight bias

Another common perception bias is hindsight bias. This bias tends to occur in situations where an investor believes that the onset of some past event was predictable and completely obvious, whereas in fact, the event could not have been reasonably predicted.

Consider

Many events seem obvious in hindsight. COVID-19 reinforces the folly of this bias, as it had far less predictability than events such as the global financial crisis, 1987 stock market crash, Asian financial crisis and tech crash of 2000.

Psychologists attribute hindsight bias to our innate need to find order in the world by creating explanations that allow us to believe that events are predictable. Hindsight bias is a cause for one of the most potentially dangerous mindsets that an investor can have. That is, overconfidence.

4. Gambler's fallacy

In the gambler's fallacy, an individual incorrectly believes that the onset of a certain random event is less likely to happen following an event or a series of events. This line of thinking is incorrect because past events do not change the probability that certain events will occur in the future. It is important to understand that in the case of independent events, the odds of any specific outcome happening on the next chance remain the same regardless of what preceded it.

Buying a stock based on the belief that the prolonged trend is likely to reverse at any moment is irrational. Investors should instead base their decisions on fundamental and/or sound technical analysis and reasoning before determining what will happen in light of a trend.

Example 3. At odds with odds

If a coin is flipped and lands on heads one hundred times, what is the chance of the coin landing on tails the next go?

The answer is 50/50, given each flip is an independent event. The same logic applies to directional movements in the stock market—the market returns of previous days do not dictate what will happen next.

Consider

In the context of COVID-19, some investors have taken the view that the trend is prolonged and are cautious, while others are buying at what they perceive to be the bottom of a bear market.

The fact is nobody knows how things will eventuate, and investors should avoid speculating. If a portfolio is constructed with appropriate levels of diversification, often it is better to 'do nothing'.

5. Herd behaviour

Herd behaviour is the tendency for investors to mimic the actions of a larger group. Individually, however, most people would not necessarily make the same choice. Herd behaviour, or 'herding', can happen due to the pressure to conform and the assumption that it is unlikely that such a large group could be wrong.

Even if an investor is convinced that a particular idea or course of action is irrational or incorrect, they still may follow the herd, believing they know something that other investors do not.

When it comes to herd behaviour, it is worth remembering a simple rule of thumb from Warren Buffet: "Be fearful when others are greedy and greedy when others are fearful."

Consider

Herd behaviour is especially relevant today, given the easy access to information with the internet and seemingly endless social media platforms.

6. Anchoring

Anchoring is a cognitive bias where an investor depends too heavily on an initial piece of information (the 'anchor') when making decisions, and may subsequently over-rely on this piece of information.

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The quote

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Example 4. Exclusion of alternative viewpoints

If an investor believes a certain company is successful based on a particular metric, they may over-rely on this information and buy into the shares, dismissing other factors completely. To avoid this trap, one needs to remain flexible in one's thinking and be open to new sources of information.

7. Loss aversion

Loss aversion refers to the tendency to prefer avoiding losses relative to realising equivalent gains. Multiple studies have found that the negative emotion of losing one dollar is around twice as strong as the positive emotion of earning the equivalent amount. Investors often go to great lengths to avoid losses because of the potential psychological discomfort they may cause.

Loss aversion can help investors avoid key threats to their portfolio. However, if someone is too loss averse, they may end up holding onto a losing position with the hope it recovers, despite logic indicating otherwise.

Example 5. How loss aversion can snowball

An investor's stock falls 10%, and they are afraid to take the loss. Thus, they hold the stock for no other reason than to avoid the loss. However, the stock falls another 10%, by which time they think it is too late to take the loss. This mindset is driven by emotion, not rational analysis.

Investment decisions such as choosing to hold or sell a stock should be based on structured reasoning.

Example 6. When holding a falling stock may still be worthwhile

Someone may think a falling stock still has a good earnings profile and balance sheet. In such circumstances, holding a falling stock (and even adding to a position) can sometimes make sense.

Conclusion

During times of severe uncertainty and volatility such as the unprecedented events during COVID-19, investors can experience high levels of stress and anxiety. Behavioural biases and emotional reactions may also cloud their judgments when making decisions.

The first step to overcome these psychological traps is to have self-awareness and a good understanding of the different biases. Start by identifying biases when they are encountered and think of some coping tools in order to manage them. With practice and time, one can develop strategies to overcome these psychological traps.

Investors can also avoid these behavioural biases by speaking with an independent financial adviser to receive professional advice and counselling to help them to steer clear emotionally of these behavioural biases and traps. **FS**