DON'T LET COGNITIVE BIASES CLOUD YOUR INVESTING JUDGEMENT

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Over the years, psychologists have discovered a laundry list of cognitive and behavioral biases that influence the way humans make decisions and act. Many of those biases can easily cloud one's judgement and adversely influence one's decision-making process when it comes to investing. History has shown the most successful investors have developed a regimented process and series of rules that objectively tells them when to buy and when to sell – then, of equal importance, they stick to it. The main job of these rules is to take emotion and subjectivity out of the investment decision making process.

Simply having a system or set of rules puts you ahead of the crowd. It may sound simple, but the average investor does not have pre-defined reasons for why they buy or sell securities – maybe they hear a friend discuss their latest winner, read about a stock in the paper, or see an analyst touting a certain asset class on TV. None of these are good reasons to put your hard earned money at risk.

The trick, and most difficult part, is sticking with your system over market cycles, even when your system underperforms – we all know there is no magic bullet, and no system or set of rules is infallible. Therein is the problem. We as humans are fraught with biases, and when a period of underperformance occurs, and it will, it is easy to let emotions and biases creep into the process and cloud decisions – we begin to second guess ourselves and question the process or system. Let's consider several biases and examine how they influence decision-making.

Confirmation Bias

Mark Twain once said "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Confirmation bias is the tendency to only seek out information and opinions that confirm our preconceptions. One obvious example is to stop and take inventory of where we gather news – if we only listen to or read one news source are we even considering the other side of arguments or issues? Humans do not like to feel uncomfortable, so we tend to seek out other opinions and ideas that closely align with ours, thus confirming our point of view. In the world of investing it is important to

seek out all opinions on a stock or asset class and thoughtfully consider the other side of the trade, and why someone would take the other side.

Outcome Bias

Too often we judge a situation only by the outcome – how do we judge whether or not a good or bad decision was made. In sports, it is easy. The sports analyst can consider the reams of data to see whether a player was successful or not, i.e., how many home runs did he hit or how many touchdowns he caught. How do we define a successful outcome? If we employ a sound decision making process and the outcome is not positive, are we focused only on the negative outcome? Investing is an endeavor full of negative outcomes – research has shown that some of the most successful investment strategies result in losses nearly half of the time. Overcoming an outcome bias means to be focused on the process and let the results take care of themselves. Winning money at the casino does not necessary mean that gambling is a smart decision, or a reasonable wager of risk.

Overconfidence

How many people would say they are an above average driver? I bet very few people would say their driving skills are below average. However, by definition we cannot all be above average – to have an average implies that some are below and some are above. Overconfidence is a powerful force and it affects everyone – especially experts. Let's face it, everyone enjoys being right – there are few more satisfying words than "I told you so". However, to overcome overconfidence bias we need to accept our limitations and come to peace with being wrong – to admit to ourselves we may not know everything. A successful investment strategy is being able to admit when you are wrong and cut losses short – being wrong is fine, but the real crime is being wrong for a long time – that is when one can experience a permanent loss of capital.

Recency

This particular bias is one that can be especially harmful to investors. Recency is the tendency to rely more heavily on recent information to the detriment of the total set of information. For example, economists may make forecasts that are swayed by the current market environment or predict how the market may look in the future based on today's conditions. In other words, it can be a danger during market downturns to forecast more losses and make unwise decisions without considering the mean reverting tendencies of markets. No bull market can last forever, and no bear market can persist indefinitely. It can also cause investors to evaluate their current portfolio based on recent performance – this can be a dangerous proposition in any type of market environment. This bias is best combatted by first having a regimented investment strategy that is process focused not results oriented, and then relying on that strategy regardless of near-term outcome.

Blind Spot Bias

The blind spot bias is the all-encompassing bias which suggests that while we can easily recognize tendencies in others, we have a difficult time identifying those same biases in ourselves. A lack of self-awareness that prevents us from seeing our own biases is a bias in and of itself. In order to overcome any bias we must first acknowledge that the bias exists, or is at least possible.

In investing there are many ways to generate returns which will lead to a positive long-term outcome. The key is to choose a method that complements your personality and repeat it over various market cycles, through the ups and downs, over the long-term. When biases creep in, and they will, they must be recognized and identified before they negatively influence the strategy and cloud your investment decision making process.

For as long as humans have been on the earth, there have been biases; indeed most biases have at times been a necessary component to the survival of our species. Recognizing patterns and employing some of these biases allowed prehistoric mankind to avoid being eaten by predators – those same skills today, however, can be detrimental to our financial well-being.

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