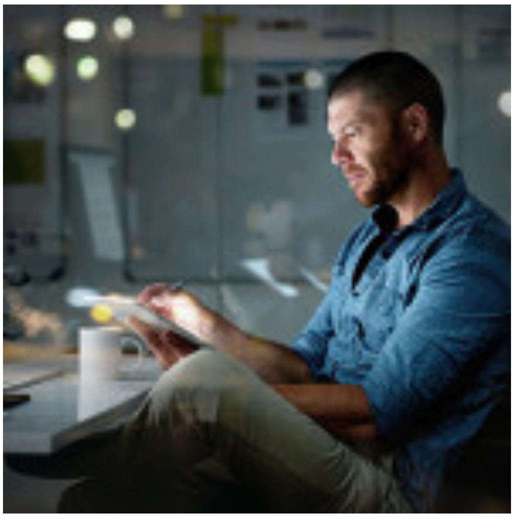
How Behavioural Biases Can Affect Your Financial Plan

Whether we are aware of them or not, we all carry biases which shape our thoughts and behaviour. Most investors know that making decisions based on emotion is likely to be counterproductive. But what about those subconscious beliefs that can fool us into thinking we are making an entirely rational choice?

Biases are apparent in all areas of life, and financial planning is no exception. It is only when we explore the reasons for the biases, and look past them, that we can make genuinely objective decisions.

Confirmation Bias



Have you ever started with a theory or a hunch and decided to carry out further research? Do you notice how straightforward it is to find information that supports your original view, while opposing evidence can be easily debunked or cast aside?

That's confirmation bias. When we have a particular belief, we are naturally inclined to seek out evidence in favour of it. The more we find, the more this enforces the belief, making it easier to ignore or discredit the opposite view.

Confirmation bias stems from two things. Firstly, we like to believe we are right. And secondly, you can prove just about anything with statistics. The truth is rarely black and white and it's not always easy to see the nuances.

In financial planning, we might favour a particular company or investment and look for reasons to use them, rather than taking an objective view. An independent financial adviser, by definition, must look at the whole of the market when making recommendations. Seeking advice can help you see the wider picture and make decisions based on evidence.

Overconfidence Bias

Overconfidence bias occurs when we place too much faith in our own judgement.

Evidence has proven that it's virtually impossible for an individual investor to consistently 'beat the market.' This is particularly true when trading individual stocks and attempting to buy and sell at the right times. The market is too unpredictable, and any information that could affect your decision is already priced in.

But people still trade shares. This suggests that a huge number of investors place greater confidence in their own stock picking abilities than that of a professional manager, or the steady predictability of a passive fund.

Successful investing doesn't just mean supercharging your growth in the short term. It's also about managing risk and coping with the inevitable downside. Over the longer term, a diverse investment strategy that stays on course is likely to improve long-term growth prospects.

The Gambler's Fallacy

Past performance is not necessarily an indication of future performance. This statement appears throughout the financial services industry and is intended as a reminder that just because a fund has had a good run, this doesn't mean it will continue.

But top performing funds attract attention, and therefore investment. This boosts the share price as demand increases. Eventually, this levels off, and another fund takes the top spot. And so it continues.

The gambler's fallacy arises from a belief that just because a horse (or a fund) has performed well, it will continue to do so. Often, this doesn't include in depth research into the reasons for the success or the underlying holdings. Many of the top performing funds in 2020 benefited from the circumstances, i.e. an increased demand for tech and healthcare products. That doesn't mean that the same funds will outperform in 2021 or 2022 as it's likely that other trends will take over, like commodities as a hedge against rising inflation.

When investing, it's important to look at factors other than past performance. As always, diversification is vital, as this can help to capture market trends that might otherwise be missed.

Loss Aversion

No one wants to lose money. In financial planning, sometimes we can take actions that are interpreted as 'cautious' or 'risk-averse' to avoid losses. For some investors, the pain of a loss can far exceed the elation of a gain.

But keeping all of your money in cash is not simply cautious. It's creating a loss in real terms, as your money will lose spending power in every year that inflation rises. By eliminating one risk (investment fluctuations) you are creating another (inflation risk).

Similarly, selling investments when the market is falling is not a prudent move. It can prevent further losses, but what about the losses that have already occurred? When do you decide to buy back in? A habit of selling when the market is falling and buying when the market is rising is far less efficient than simply buying and holding.

Fluctuations are part of investing, and therefore part of financial planning. Rather than trying to avoid market dips, the secret is to understand how you will cope when (not if) they occur.

Herd Mentality

Herd mentality, or 'groupthink' means following the crowd.

Investment prices are driven by supply and demand. This not only relates to the underlying assets, but also to investor appetite for a particular fund or share. So, if a particular stock falls out of favour, investors often believe they are taking the safe route by copying what everyone else is doing. But this causes the price to drop further, and those at the back of the queue will probably lose more than if they just stayed invested.

Cryptocurrency has been excellent example of this, as the wildly fluctuating values are based on little more than trends and opinions shared on social media.

Sometimes success comes with taking your own path rather than following the herd.

Simmons Consulting can help you to overcome biases and take an objective look at your financial situation.

Please don't hesitate to contact a me to discuss any aspects your financial planning.

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