Investor Biases

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INVESTMENT DISCIPLINE

Investors do not always make sound investment decisions. Human emotions unwittingly cause investors to fail through self-destructive behaviors. These negative behavior patterns often interfere with achieving optimal returns. We call these suboptimal returns the behavior gap. The "behavior gap" is a term coined by Carl Richards and has become a popular way to refer to the loss of investor returns due to emotional decisions.

Common investor biases:

1. **Herding:** Buying or selling when everyone else buys or sells.

   "Everyone knows that technology stocks will be the fastest growers."

2. **Loss Aversion:** Tendency to strongly prefer avoiding losses to acquiring gains.

   "I will wait in cash until it is safe to get back into the market."

3. **Sunk Cost Fallacy or Anchoring Effect:** Irrationally including costs that have already been incurred as a factor in future decisions.

   "I will sell my losing stock as soon as it gets back up to what I paid for it."

4. **Confirmation Bias:** Selectively seeking out information that agrees with preconceived beliefs. Ignore or undervalue information that disproves beliefs.

   "That analyst is smart because he recommended my stock."

5. **Recency Bias:** Overemphasizing recent information and falsely believing that short-term performance is indicative of future outcomes.

   "If the stock market keeps going down, I will lose a lot of money."

6. **Hot Hand Fallacy:** Mistakenly believing that success with a random event has a greater chance of being repeated.

   "Since I made money on those stocks last year, I know I will again this year."

7. **Framing Effect:** Reacting to information based on how it is presented.

   "That investment you showed me looks like a sure thing, and I don't want to miss out."

8. **Illusion of Validity:** Overestimating the ability to *interpret or accurately predict an outcome.*

   "I know this stock will be a winner."

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