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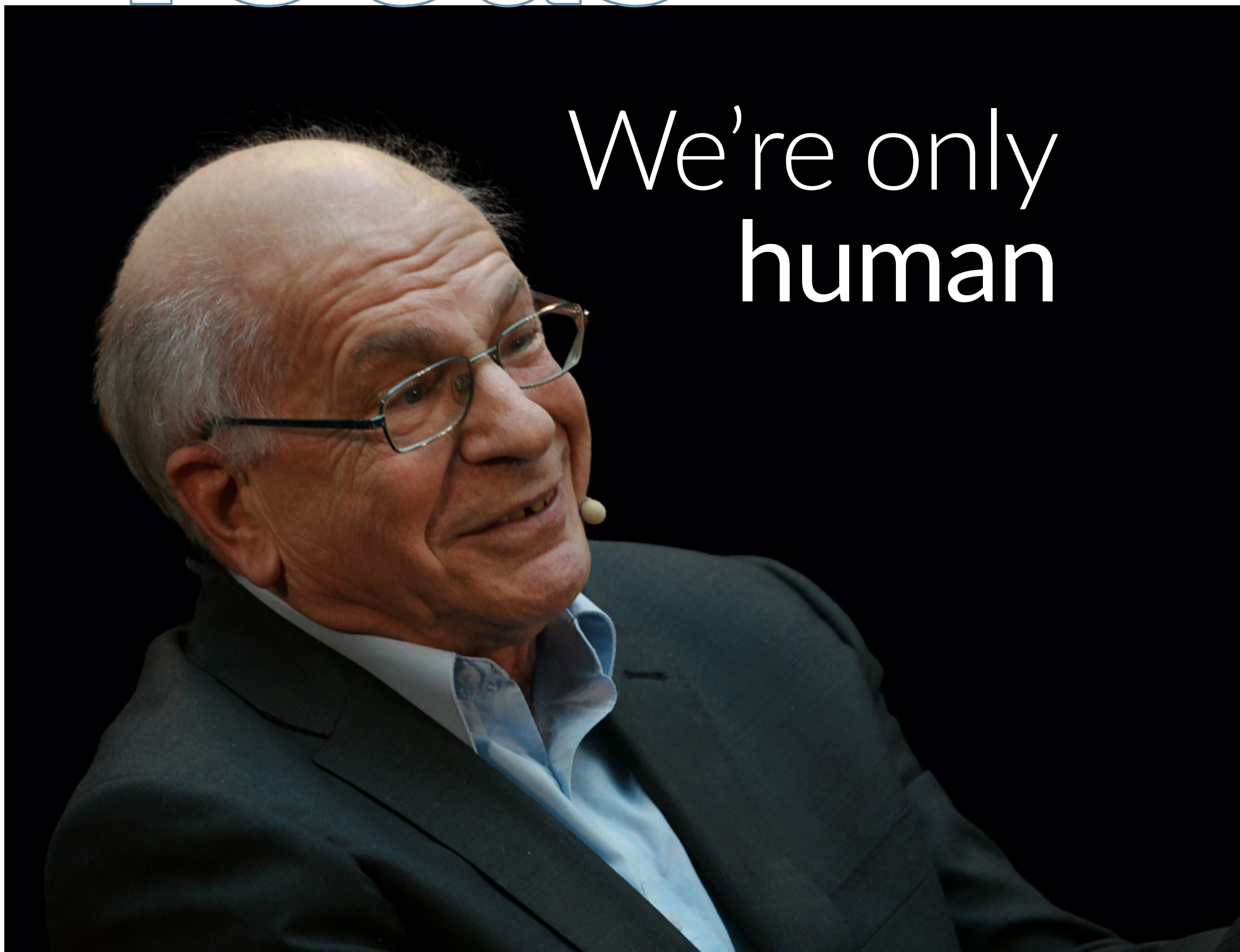

Last week psychologist Daniel Kahneman passed away, aged 90. Kahneman, alongside his Israeli compatriot Amos Tversky, pioneered the study of behavioural economics. The pair explained how people's decision-making is not completely rational and how it's affected by biases and heuristics (mental shortcuts that are hardwired into our brains). These biases and heuristics are extremely useful for navigating everyday life, but unfortunately, they are less helpful when it comes to successful investing.

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...Las Vegas is busy every day, so we know that not everyone is rational...

> *"Las Vegas is busy every day, so we know that not everyone is rational."*

Charley Ellis, US Investment consultant

Despite what the "science" of traditional economics assumes, humans are not completely rational. The study of behavioural economics combines psychology and neuroscience with economics to understand how and why people make the decisions they do.

The most famous work in the field was undertaken by two Israeli psychologists, Daniel Kahneman and Amos Tversky in the 1970s and '80s. Their contributions were recognised with Kahneman being awarded the Nobel Prize in Economics in 2002 — Tversky passed away in 1996.

Humans developed biases and heuristics to survive and thrive as hunter-gatherers (which we have been for most of our 300,000 year history). In daily life they are invaluable, helping us to efficiently make thousands of simple decisions every day. For example, when deciding what to have for breakfast, the familiarity bias might lead us to choose a favourite cereal without pondering all possible options. The recency bias helps us assess risks based on recent events such as choosing to take an umbrella because earlier you got caught in the rain. Without these mental shortcuts we would be paralysed by analysis, unable to make the myriad of small decisions required in daily life.

There are areas, however, where mental shortcuts can become traps. Financial markets are characterised by uncertainty, complexity, and the need for rational analysis — conditions under which biases and heuristics can lead to errors in judgement. Here's a quick guide to six common biases identified by Kahneman and Tversky that often prove detrimental to healthy investment returns.

1. Loss aversion

> *"If owning stocks is a long-term project for you, following their changes constantly is a very, very bad idea. It's the worst possible thing you can do, because people are so sensitive to short-term losses. If you count your money every day, you'll be miserable."*

Daniel Kahneman

People's aversion to losing something they have outweighs the pleasure they obtain from gaining something new. By a lot. Research suggests about 2¼ times more! That means in an even

money wager (where the chance of winning and losing is the same) the average person would need the possibility of winning at least $225 to outweigh the pain of a potential $100 loss. Evolutionary instincts are thought to be the root of this bias. For our ancestors the loss of food or shelter could be fatal, while gaining a bit extra simply provided a little more comfort.

Some degree of loss aversion is valuable. For example, if losing $2,000 means you can't meet next month's rent, whereas gaining $2,000 means you can buy a new phone, it's clearly logical to play it safe and have a bed to sleep in.

However, our irrationality around potential losses means many investors take less risk than they should. Over the long term less risk generally means lower returns. Even more counter-productively, loss aversion is usually heightened when news reports are negative and market prices are falling — in other words, when opportunities may be at their greatest. Loss aversion contributes to investors panicking and pulling out near the bottom of a market downturn, then missing out when asset prices recover.

2. Herd behaviour

Humans naturally want to be part of a group or community. For our ancestors it meant a greater chance of defending themselves against a rival tribe or sabre-tooth tiger.

Herd behaviour or herding in markets is when investors simply follow what others are doing, rather than making individual decisions. It can mean individual stocks or even an entire market can move, up or down, for no obvious fundamental reason. At extremes, it can lead to market manias such as the dotcom bubble of the late 1990s/early 2000s. Many investors followed the crowd and continued to buy technology and telecom stocks despite extreme valuations. When the crowd stopped buying, prices plummeted.

3. Confirmation bias

Experiments show that people tend to seek out and interpret information in a way that supports their existing views and dismiss information that refutes those views. Confirmation bias makes us less likely to see our mistakes before it's too late. As Mark Twain 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."

4. Familiarity or "home market" bias

Humans can be creatures of habit. We all know people who shop at the same place or buy familiar brands. Familiarity can be equated with safety — we know what we're getting. Eating those strange berries could make you sick (or even kill you!).

Familiarity bias can impact investment portfolios by causing people to invest too heavily in their home country (a "home market bias"), or in companies they know well or whose products they use. Owning what they know can feel safer.

Diversification has been called 'the only free lunch in finance'. When you build an appropriately diversified portfolio you bypass your own home market bias, giving yourself a real opportunity to maximise the return for the risk you are taking.

5. Overconfidence

In a famous piece of behavioural economics research, 93% of Americans judged themselves to be above average drivers. This mathematical impossibility is not limited to drivers. It has also been proven that some investors tend to attribute good outcomes to their own skill, but poor outcomes to bad luck or things outside their control.

Overconfident investors take on more risk, trade more often (incurring higher transaction costs), chase the new "hot" investment idea (see extrapolation bias below), earn lower returns, and are more likely to be male than female.

6. Extrapolation or recency bias

People think the future is more predictable than it really is. Why? One reason is that we tend to lend more weight to recent events when predicting what will happen next. In 2008, when the oil price spiked to US$180 a barrel, experts predicted it could go to US$200 or even US$300. By January the next year it had fallen to US$55 and has never reached those 2008 highs since. People didn't predict new technologies that enabled extraction of oil from deep deposits of shale, improved the efficiency of consumption, or lowered the cost of alternative energy sources like solar and wind.

A principle of investing is that past performance does not indicate future performance. What delivered investment returns in the past is not guaranteed to do so in the future.

...people who work with an adviser do, on average, earn significantly higher long-term returns...

So now you're protected from your own biases? Sorry, no!

You may be thinking that knowing about these biases means you won't fall victim to them. Sorry, but no! Research shows that knowing you're biased is no guarantee against making biased or irrational decisions. Daniel Kahneman literally wrote the book on the subject (*Thinking, Fast and Slow* was a best seller published in 2011), but recognised "It's not a case of: 'Read this book and then you'll think differently. I've written this book, and I don't think differently."

So what hope is there? There are strategies that offer some protection. Take your time to formulate a long-term investment plan, check it for inherent biases (not just with yourself, but with someone independent), and then stick with it. And remember to lean on your adviser. The evidence is clear, people who work with an adviser do, on average, earn significantly higher long-term returns. A key reason for this is having someone to talk to before you act reduces the chance you'll do something rash you might later regret.

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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