6 Cognitive Biases

That Can Be Costly to Your Long-Term Wealth

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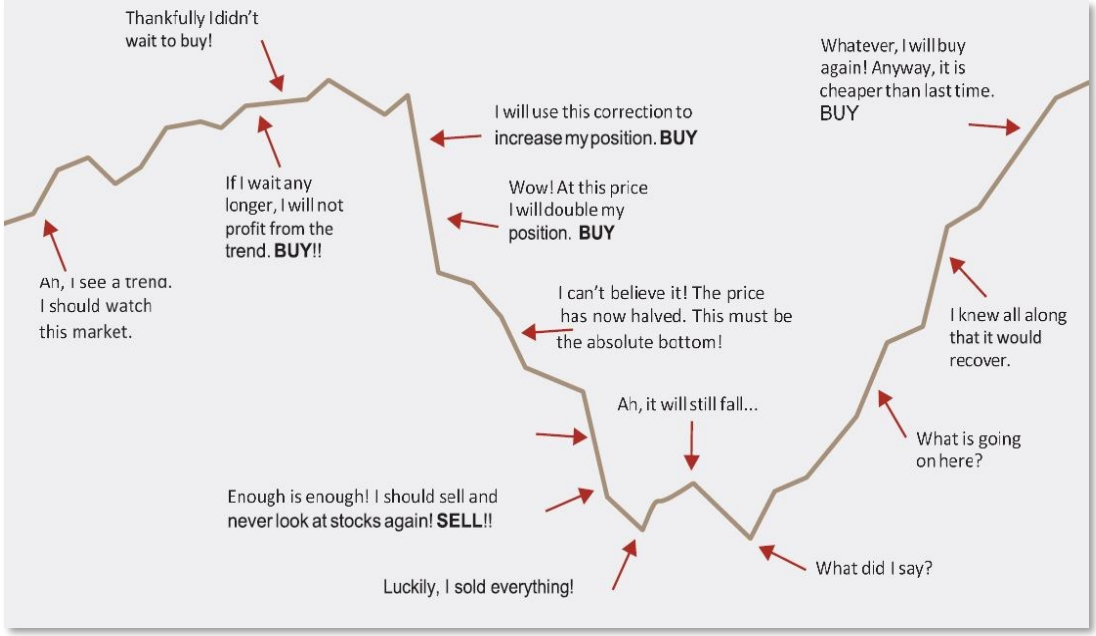
> *"The worst enemy of the investor is most likely himself." - Benjamin Graham*

With the U.S stock markets reaching all-time highs and many analysts warning that many companies are being overvalued by investors, it seems like a good time to discuss some of the psychological biases which can negatively influence investor behavior:



Confirmation Bias

We all have a tendency to actively seek out information that supports opinions we have already formed and to digest facts which suit our own world view. Investors have a tendency to avoid critical opinions and reports published about investments in which they already have large positions and seek and look for confirmation from analysts and the media that the decisions they have made to buy the stock initially and to keep it, are still good ones. Just as great leaders will listen intently to those with whom they disagree, great investors should listen to the growling bears going in the opposite direction from the thundering herd of bulls.

Anchoring Bias

The price an investor initially pays for a stock can act as an unfortunate psychological "anchor" that can lead to irrational decisions about the future value of the company. A confident investor buys what they think is a great company at a perceived bargain price of $100 per share; only to see bad news about the company and economy causing the price to drop to $50 during the next two months. The fact that the investor paid $100

initially can cause an irrational assessment of the potential of the company at its new price "Great!! I will double my position at this new price" in reality the initial price of $100 paid by the investor has nothing to do with the company's growth potential if purchased at its new price of $50 -but it is perceived as a cheap price based on the much higher price paid initially.

Myopic Loss Aversion Bias

Investors must manage the battle between fear and greed in their heads and stomachs to be successful in accumulating wealth in the long term. Unfortunately, the fear of loss is generally a more powerful force that overwhelms many investors during periods of steep losses in stock prices. Even though the investment might not be planned to be liquidated for decades, many investors panic during corrections and bear markets; causing them to miss out on the recovery in prices that follows. Warren Buffett has described his legendary approach to value investing in this simple way, "When the herd is greedy I am fearful, when the herd is fearful, I am greedy."

Playing with the house's money

Casino operators and professional poker players are very familiar with this behavior. A novice gambler makes a trip to Oxford Casino with $500 in their pocket to gamble. Their decisions on whether to hold'em or fold'em in any given hand can be greatly influenced throughout the night based on whether they have more or less than the initial $500 in their pocket. If they "win" $300, they may be more likely to make aggressive bets with the $300, which is the "house's money" than they would if they had less than the initial $500 in their pocket.

Investors often react the same way. Consider two investors: one who purchased $10,000 worth of stock in Amazon at $30 per share two years ago. The second purchased $10,000 worth of stock in Amazon at $50 per share today. If the price drops back to $30 over the next few months, the first investor may be less likely to sell.

Overconfidence Bias

This is the "Lake Wobegon" effect—even though study after study has shown that it is virtually impossible to time the markets and be in only when prices are going up, many investors overestimate their own abilities. In an effort to feel in control and "in the know," many investors subject themselves to unnecessary transaction costs and income taxes and miss out on much of the appreciation in the markets by attempting to be out during falling prices. The sad reality is

that many investors in any given stock or mutual fund earn significantly less over time than what the investment provides for in long term returns, due to trading in and out and chasing last year's winners.

Framing Bias

Decisions to invest in a company can be greatly influenced by the way the statistics are framed. If I told you that I once combined with a teammate to score 55 points in a single college basketball game you would assume me to be a much better player than if I "framed" the statistics with the rest of the story, that he scored 49 and I scored just 6!

A company's presentation of itself is never random. "Our profits surged 150% and our revenue grew by 50% over last year" sounds good until you find out that last year was the worst year financially in company history. "Our stock price reached an all-time high recently at $100 per share" sounds awesome until you learn that the price hit $99 a decade ago.

The magic of a consistent, repeatable investment process

I am often asked what "secret sauce" we use at Golden Pond that gives us the ability to grow and protect our clients' wealth over the long term. Well, there is no secret sauce or magic formula. Quite simply, successful long-term investing requires both our clients and us to leave our emotions, egos and the "6 Cognitive Biases" in this article at the door. Instead, we embrace a boring, plain vanilla, disciplined process which has stood the test of time over many decades.