EMOTIONS CAN COST YOU MONEY

Even the most experienced investors can fall prey to their emotions. And then pay the price. It's easy to forget that our financial decisions are sometimes influenced by our emotions or by erroneous information.

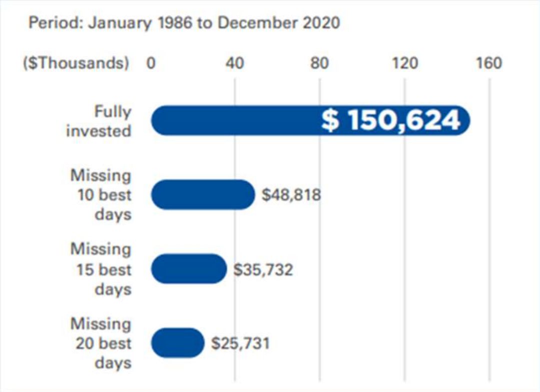
Behavioural finance

Behavioural finance helps us understand our cognitive biases and why we make errors in judgment and irrational decisions.

The field combines psychology and economics to help us identify and manage our behavioural biases, that is, the kinds of reasoning or emotions that lead to poor decisions.

A high-stakes issue

Reacting to market events without thinking can cost us tens of thousands of dollars. As the following example shows, if a person invested $10,000 in 1986 but then missed the ten best days in the stock market because they were influenced by their emotions, they would have earned $100,000 less by 2020 than if they had left their money invested for the full 35 years.*



Behavioural biases

The biases that affect investor behaviour fall into two main categories. First are the cognitive biases, which lead to errors in judgment because we tend to oversimplify. A good example is the belief that a stock's past performance is an indicator of its future performance.

Second are the emotional biases, which lead people to make decisions based on their emotions: an example of this is panic selling when markets drop.

There are a number of biases that can affect our financial and investment decisions. The main ones are:

Anchoring

Anchoring bias comes from our tendency to estimate the value of a product or service based on information that isn't relevant. For example, an investment's past performance does not guarantee its future performance. Anchoring is a common sales technique: an item listed at an artificially high price becomes "anchored" in our mind, so we see any drop in price as a good deal.

Loss aversion

This bias refers to our tendency to give more weight to losses than gains. Loss aversion makes us hold on to a losing stock far too long; we fear taking a loss if we sell, and we cling to the hope that the stock will eventually rebound.

Fear

Fear is a powerful emotion that triggers us to sell at the first sign of trouble. For example, many investors will panic and sell their shares during a market downturn, even if they believe in the long-term prospects of the companies they've chosen to invest in.

Greed

This bias can lead us to take unnecessary risks to earn high returns. For example, some investors choose to invest in speculative stocks or cryptocurrencies without fully understanding the risks.

Confirmation bias

With confirmation bias, we tend to notice or look for information that confirms our existing beliefs or impressions. And we ignore anything that contradicts them.

Optimism

This is another potentially dangerous bias, as it leads us to underestimate the risks of our financial decisions. A good example is thinking that certain situations "only happen to other people."

The bandwagon effect

We've all heard about "herd mentality," which is the tendency to think and act like everyone else. When we make financial decisions, we tend to copy what others do without thought. Going along with the crowd has been the cause of many stock market frenzies.

Overconfidence

As the word indicates, we become overly confident in our own knowledge about investments, and we underestimate what we don't know. Making good investments doesn't always mean that we're smart investors, just as bad investments aren't necessarily due to bad luck.

All these biases are psychological pitfalls that can lead us to make poor financial and investment decisions.

Avoiding mistakes

To keep our biases from influencing how we manage our finances, we need to be aware of them. Once we understand how our emotions can affect our judgment, it's easier to recognize the signs that we may be about to make decisions based on impulse.

Another way to attack the bias problem is to have a long-term investment strategy. A clearly defined strategy will help you make informed decisions based on reason, not emotion, and keep those costly impulses at bay.

* Source: Refinitiv. S&P/TSX Composite Index total returns from January 1, 1986 to December 31, 2020. Past performance is no guarantee of future results.