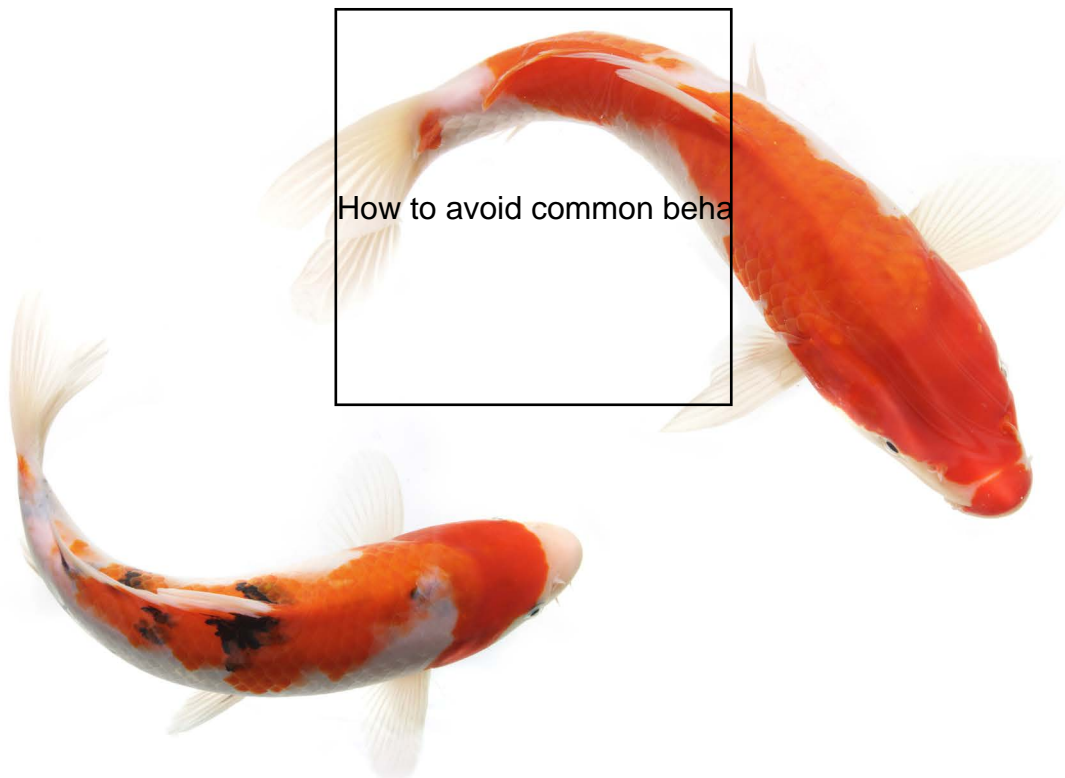
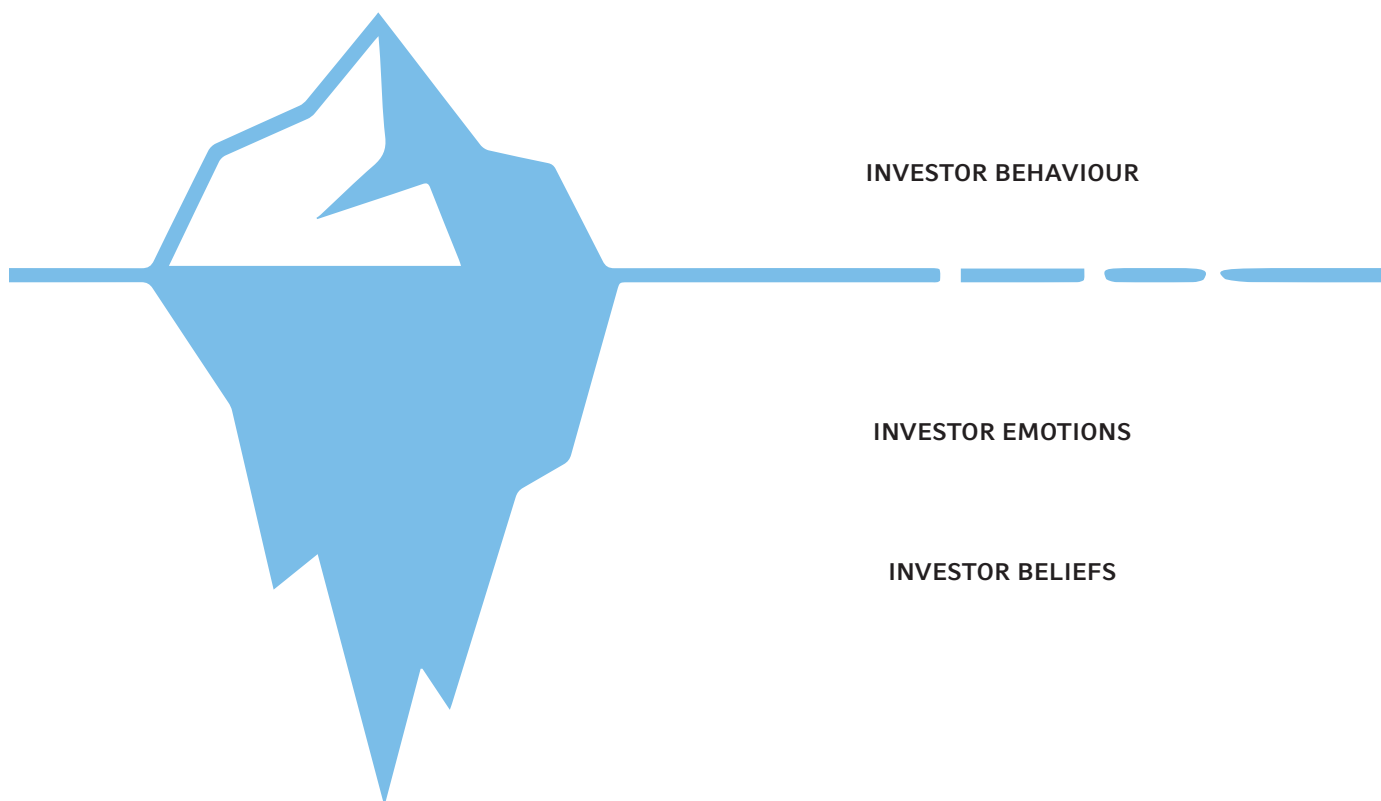


# BEHAVIOUR

## How to avoid common behavioural biases





## What drives investors to select one response over another?

It depends on a number of factors: what the investor's objectives are, including their risk tolerance and return target, what the investor's beliefs are about where they are in the market cycle and what markets will do next within the investor's time horizon. Depending on investor's beliefs, preferences, emotions and past experiences (all invisible to the market), they can come to contrasting conclusions, resulting in different investor behaviour and sometimes opposing investment strategies (the only things visible to the market).

**For example, if markets fall 10% and news headlines about an increased probability of near term recession fuel anxiety in investors' minds, the following may happen:**

- A common response may be to stop investing until markets stopped falling;
- Some worried investors may even start selling in case it's the start of a bear market;
- Contrarian investors may see the market correction as an opportunity to buy stocks 'on sale' at lower prices.

Same event. Three different types of behaviours.

**Conversely, if markets or particular asset classes, sectors or stocks rally, the following may happen:**

- A common response may be to follow the herd and join in the buying activity, bidding up prices;
- Some cautious investors may wait and see if the rally will be sustained before investing;
- Contrarian investors may sell because they believe the prices are too high.

Some beliefs may lead to successful investment strategies and behaviours. However, other beliefs may lead to behavioural biases that are counterproductive and jeopardise the likelihood of achieving an investor's objectives.

## Herding

Humans tend to mimic the actions of the larger group



## Overconfidence

Humans tend to over-estimate or exaggerate our ability to successfully perform tasks



## Familiarity

Humans tend to prefer what is familiar or well-known



## Mental accounting

Humans tend to separate their money into separate accounts



Buy high,  
sell low

Trade  
too often

Overweight  
home country

Naive  
diversification

## Examples of behavioural biases & portfolio implications

To understand what these biases are and why investors exhibit them, we need to remember that our human brains are hard wired for a world of limited and poor information, described as System 1 by behavioural finance specialists (or 'Blink')<sup>1</sup>.

Historically, survival depended on quick pattern recognition and decisive action. As a result, stereotyping and generalising have proved helpful in survival.

However, when it comes to investing in a world of uncertainty, these traits can push investors to find patterns that may not actually exist, especially for short term horizons.

### "BLINK": SYSTEM 1

Fast: Freeze, flight or fight  
Intuitive/Autopilot/uncontrolled  
Ignores some information due to speed  
Developed over many years  
Prone to predictable, systematic errors  
Unconscious/effortless  
Associative

### "THINK": SYSTEM 2

Slow: Considered  
Rational/Intentional/controlled  
Includes all relevant information  
More recently developed  
Can be trained, rule-following  
Self-aware/deliberate  
Deductive

What are the implications for investors and portfolios if these biases are not kept in check? We will first consider some common bias, what behaviours they may lead to and how the biases may be overcome<sup>2</sup>.

<sup>1</sup> Source: 'System 1' and 'System 2' terminology taken from Daniel Kahneman, Thinking Fast and Slow.

<sup>2</sup> Multiple biases may contribute to some particular investor behaviours and investment strategies.

## Buy high, sell low

Contrary to the key to successful investing – buying low and selling high, many investors end up doing the opposite. This can inadvertently result because of:

### Herding biases

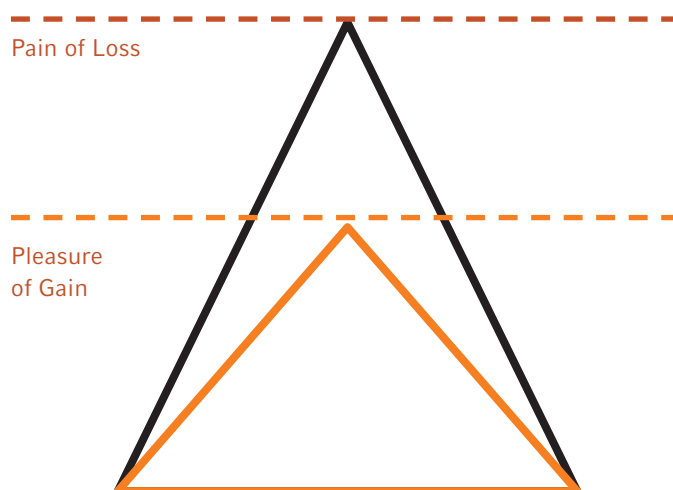
Humans tend to mimic actions of larger group and follow the crowd, e.g. if everyone selling, you sell too and vice versa. Herding comes from our evolutionary need to fit in with the majority because exclusion from the pack can be dangerous as there would be less protection from predators.

### Greed

Many investors strive to extract every dollar of profit out of a position before selling out of the investment, which may mean they end up selling after the stock or market has peaked. Alternatively, it can mean buying when the market has already run, at higher prices after others have already made money and identified opportunities early. In both cases, it could be due to investors assuming the market will follow a pattern and continue the rally or decline.

### Fear and loss aversion

Humans tend to prefer avoiding losses than acquiring equivalent gains: If someone is confronted with equal amounts of loss and gain, the pain they experience from loss is nearly twice as strong as the pleasure of the gain<sup>3</sup>. Some investors may sell at low prices as the market is falling to avoid more losses despite the investment being a sound one and helpful to achieve their long term objectives. They may also miss out on true buying opportunities for fear of negative market sentiment continuing the downward trend<sup>4</sup>.



## Trade too often

In addition to herding bias, greed and fear emotions, investors may trade too often because of an overconfidence bias: humans tend to overestimate or exaggerate their ability to successfully perform tasks. Russell Investments' recent global analysis showed that the average investor's inclination to chase past performance has cost them 2.0% annually in the 36 year period from 1984 - 2021<sup>5</sup>.

## Home bias & country specific risk

Humans tend to prefer what is familiar or well-known. One of the common results of this in portfolios around the world is the home country bias: the tendency to allocate a greater portion of one's portfolio to assets domiciled in your home country. For example, 75% of retail share owners in Australia hold only domestic shares despite Australia being less than 3% of the global market capitalisation<sup>6</sup>. Our global analysis shows that regardless of which home country the investor resides in, this phenomenon is shared across most countries. The home country bias limits the amount of diversification in investor portfolios and exposes investors to significant country-specific risk.

<sup>3</sup> Source: Advances in Prospect Theory – Cumulative Representation of Uncertainty, Tversky and Kahneman, 1992.

<sup>4</sup> Also related to regret aversion bias: fear of bad outcomes and desire to avoid blame for poor result, e.g. fear of missing out on fads or stay out of market to avoid downturn.

<sup>5</sup> Source: "Average" Investor – Russell Investment Group, Refinitiv DataStream. Return was calculated by deriving the internal rate of return (IRR) based on ICI monthly fund flow data which was compared to the rate of return if invested in the Russell 3000 Index and held without alteration from January 1, 1984 to March 31 2021. This seeks to illustrate how regularly increasing or decreasing equity exposure based on the current market trends can sacrifice even market-like returns. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Example provided for illustrative purposes only. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

<sup>6</sup> ASX Australian Investor Study 2017, prepared by Deloitte Access Economics. <https://www.asx.com.au/education/2017-asx-investor-study.htm> Australia's market capitalisation in the FTSE Russell Developed Large Cap Index is 2.5% as at 31 May 2018.

## How to avoid behavioural bias

As humans, we all suffer from some biases. But many of these can be reduced by a robust, objective and disciplined process.

As more and more investors prepare to retire and financial markets remain unpredictable, it will be increasingly important to keep behavioural biases in check.

### A trusted financial adviser can help:



1

Provide education on potential biases and how to recognise whether they are affecting investment decisions



2

Take an objective view of how any decision can have a long-term impact on a portfolio



3

Create a process that considers an investor's goals, circumstances and preferences to keep them focused on their long-term outcomes

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