Human Nature and Investment Decisions

Everybody likes to think they make sensible decisions, but the reality is that no one is quite as rational as they believe.

This seems particularly true in times like 2020, when we seem to be bombarded daily with uncertainty about COVID, vaccines, lockdowns, job losses, elections etc etc - the list seems to be endless!

Globally, focus was on caring for friends and family when the pandemic first hit at the beginning of the year, and the continued stock market volatility was - and still is - a challenge, with investors understandably concerned about the values and the long-term financial outlook. During times of trouble, people seem more susceptible to making emotional decisions, which makes the risk of potentially dangerous knee-jerk reactions just a bit higher.

The Israeli psychologist Daniel Kahneman won the 2002 Nobel Memorial Prize for Economic Science for demonstrating how humans are prone to biased decision-making.

Perhaps in these challenging times, we should be aware of some of these common biases Kahneman identified in his theories.

Loss Aversion

Experts say that humans feel the psychological pain of losing around twice as powerfully as the pleasure of a gain.

They simply hate to lose!

For example, Kahneman found that people's decisions can be swayed by how the situation is framed. When people were asked to hypothetically decide what procedure to take to cure a fatal disease, most preferred a procedure that saved 80% of people to one that killed 20%.

It's not difficult to see how this relates to a financial context. Many will naturally pick a fund 'guaranteed to match the performance' of an index, over a fund which is 'as volatile as' the (same) equity market.

When making investment decisions, people are more likely to focus on risks over potential gains. Individuals may be unwilling to make financial decisions that represent loss, such as selling an investment that has fallen below the price at which it was purchased, even though the decision itself may be the best option.

The Semmelweis Reflex

Back in the 1800s, Hungarian doctor Ignaz Semmelweis noticed that patients tended not to suffer 'fevers'(what we now know to be infections) if doctors washed their hands before they performed surgery, or assisted with childbirth.

Semmelweis assumed his observations would drive a revolution in hospital hygiene, but it just didn't happen.

This is because his theory that there was one easily-prevented cause of disease, contradicted the prevailing medical theory, which insisted that diseases had multiple causes, so simply washing hands would make no difference!

In investment terms, this idea suggests that investors might often reject new information, simply because it contradicts their own established beliefs. For example, someone might believe that a certain percentage of their assets must be in fixed interest, based on their age, for no other reason than that they have always believed it.

Overconfidence

When faced with a tricky situation, we all have a tendency towards ‘fight or flight'.

From an investor perspective, those who choose to ‘fight' are likely to be those who are highly-engaged, glued to market updates and might ask for regular changes to their portfolio, regardless of whether this is effective or not. Those preferring ‘flight’ tend to be those who simply choose not to look, in the hope all will work out in the end.

We may want to question why there are large, seemingly unprovoked fluctuations in stock markets, and should the unprovoked fluctuation provoke us the make changes to our investment? Or why people drive to a distant shop to save $5 on a small purchase, but not for the same discount on an expensive item, confident that a mere $5 saving on the larger item is poorer value.

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Familiarity Bias

A familiarity bias often shows itself as a reluctance to change from the ‘status quo’ and occurs when an investor only wants to invest in assets they know well.

They might only want to consider FTSE 100 shares, for example, and shy away from other assets that could drive returns.

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Kahneman also has some advice on how to make important decisions. "You should slow down and get advice from a particular kind of person. Somebody who likes you but doesn’t care too much about your feelings. That person is more likely to give you good advice."