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What is Behavior Investing?

Behavioral investing' is term to describe the psychological forces that can have a profound influence on investors' decisions. Christian Gattiker, Head of Research, sheds light on what these forces are and what impact they have on behaviorstment behaviour and how to avoid their pitfalls.

Which is the better investment – one with a 50/50 chance of a significant profit and a 50/50 case of an equally large loss or one with a much lower probability of a loss and a disproportionately smaller but safer gain?

Presented with such a choice, most investors would opt for the investment **with the lower risk of loss.** Yet mathematically, the expectation value of the first is higher than the expected value of the second. The first is the rational choice, but it doesn't look or feel that way. It seems emotions nearly always override logical reasoning.
Why is this, and is there anything that can be done to counter their influence on investment decisions?

"Every human being is driven by emotions – more than we would like to admit. Emotions are the drivers of our behaviour, and these behavioural patterns shape our way of investing, for better or worse," says Christian Gattiker, Head Research at Julius Baer. **Emotions are so powerful that even when we are forewarned, we still fall prey to their influence. "People often have to find out the hard way that intuition and emotions are a trap."**

One of the most common traps is the tendency to sell shares that are gaining in value too early while holding on to shares that are losing too long. "This is a very common behaviour and one of the most typical pitfalls," says Gattiker. "On the one hand, people see a gain and want to cash in now for fear it will reverse. On the other hand, they fall in love with a stock and don't want to believe it has gone out of fashion. No one is immune to these behavioral traits; they affect not just private investors but professional fund managers, too."
The difficulty is that people often don't know the irrational forces affecting their decisions.

The worst traps

- Attaching more credibility to stories that support our views and dismissing those that do not.
- 'Herding', where investors run in the same direction in the belief that the person in front of the herd knows more than they do.
- Paralysis caused by fear of doing the wrong thing – this phenomenon tends to occur when a market crisis and investors have been spooked.

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- Holding on to losers for too long and selling winners too early: the former is caused by paralysis at seeing the accounting value of the asset going below the purchase price; the latter is caused by impatience and the desire to cash in on a profit quickly.

Avoiding common pitfalls by applying both judgment and rules

One lesson that can be learnt is the value of rules and the importance of applying them in a systematic way. Yet this, too, is only half the story. If rules were enough, machines would consistently make better investment decisions than human beings. However, that is not the case. "The trouble with machines is that, while they are good at rule-based investment, they have no judgment. This means that they tend to be pro-cyclical," says Gattiker. "Even if they are programmed to be contrarian, they are still following the cycle."

The key to breaking out of this pattern is to use judgment and rules together complementary, not just rely on one. It's necessary to use judgment to understand the dynamics of market movements but also to make a cool, rule-based assessment of the numbers.

It's also vital to constantly expose your views to challengers. Among fund managers, this is achieved through a system of checks and balances. In each decision, at least two people are involved with very different perspectives. While decisions are driven by investment processes, they are still exposed to other views. "Seasoned professionals do not all think alike. Your portfolio will fare far better if it is run by a group than if it is run by one individual," says Gattiker.

What are the diff types of behvior biases :-

Loss Average Bias:-

Loss aversion bias is a cognitive phenomenon where a person would be affected more by the loss than by the gain, i.e., in economic terms, the fear of losing money is greater than gaining money more than the amount that one might lose so, therefore, a bias is present to averse the loss first.

Confirmation Bias:-

Confirmation bias is **the tendency to seek information that supports a person's beliefs**. This bias may lead investors to focus only on information that reinforces their opinions about an investment. Selectively choosing which data to use can lead to a lack of diversification and investments that are too risky.

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Gamblers Fallacy:-

The gambler's fallacy, also known as the Monte Carlo fallacy, **occurs when an individual erroneously believes that a certain random event is less likely or more likely to happen based on the outcome of a previous event or series of events**.

Anchoring bias:-

Anchoring is a behavioral finance term to describe **an irrational bias towards an arbitrary benchmark figure**. This benchmark then skews decision-making regarding a security by market participants, such as when to sell the investment.

Availability bias:-

In behavioral economics, the recency bias (also known as the availability bias) is **the tendency for people to overweight new information or events without considering the objective probabilities of those events over the long run**.

Hindsight Bias:-

In investing, hindsight bias may manifest as **a sense of frustration or regret at not having acted in advance of an event that moves the market**. One key for managing hindsight bias involves documenting the decision-making process via a journal (e.g. an investment diary).

Status Quo Bias:-

Status quo bias **can combine with loss aversion bias**. In that scenario, an investor facing an opportunity to reallocate or alter an investment position may choose, instead, to maintain the status quo because the status quo offers the investor a lower probability of realizing a loss.

Herd Mentality Bias:-

In behavioral finance, herd mentality bias refers to investors' tendency to follow and copy what other investors are doing. They are largely influenced by emotion and instinct rather than by their own independent analysis. This guide provides examples of how investors may succumb to herd bias as part of behavioral finance theory.

Self-Attribution bias:-

It is a characteristic of quantitative techniques or economic models whereby they tend to choose investment instruments that have similar fundamental elements. Some models used in finance will tend toward attribute bias, and investors should be aware of this as part of choosing a balanced portfolio.

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How do these biases impact decision making? :-

- **Behavioral finance biases can influence our judgment about how we spend our money and invest.**
- **The most common pitfalls include mental accounting errors, loss aversion, overconfidence, anchoring, and herd behavior.**

- **Understanding these biases can help you overcome them and make better financial decisions.**
  - Imagine you find $100 on the street. Would you spend it on an expensive meal? Or would you invest it?
  - The answer lies with behavioural finance, which examines how our brain affects how we manage and invest money.

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