GRADIDGE MAHURA INVESTMENTS

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Emotional Biases

Don't let your emotions get the better of you when making investment decisions

When it comes to investing, we all like to think of ourselves as rational human beings who are reliable and accurate in our decision making. We assume that we learn from experiences, interpret new information precisely and without bias. The reality is however that we often act emotionally and illogically which can have severe consequences on the value of our investments. Our emotions tend to be more dominant during weak and volatile market conditions such as those we have been experiencing in the past 3 years.

You may think that you're privileged and can turn off your emotions when making critical decisions, but ultimately, we're all fallible and even seemingly apparent choices can be influenced by controlling emotional biases that operate within our subconscious minds.

Emotional biases are based on human instincts including fear, hope and an overriding quest for survival. What's important is to know how to recognise these instincts for what they are and stop them in their tracks if need be when making important decisions.

Let's get to know ourselves by discussing five of the most common emotional biases.

Loss Aversion

Loss aversion in the investment arena refers to our tendency to favour circumventing losses over obtaining investment gains. It's a preoccupation with the volatility and risk of an investment rather than its potential long-term increase in value.

Are you familiar with any of these?

- You're quick to sell investments that have declined in value in fear of further loss - despite knowing that the market 'is bearish' in general
- You prefer not to sell investments to rebalance your portfolio in-line with your personal objectives as you regard capital gains tax as a loss
- You're unwilling to sell your house for less than you paid for it despite the market being sluggish throughout South Africa

Familiarity bias

Familiarity bias in the investment world is the preference for ownership of assets that we're familiar with, despite the clear benefits of diversification.

Do you find yourself doing any of the following?

- You favour local equity-based investments as you're not familiar with offshore companies - despite your awareness of currency risk
- You prefer professional proximity which means that you continue to purchase shares in the company you work for or in a similar company which you feel you understand

Recency bias

A recency bias is our tendency to believe that there's a higher probability of something happening if it occurred in the near past. In essence, we value new information over old information. It's one of the drivers behind investment cycles in that we tend to purchase investments as the markets rise in the expectation of further increases and sell when markets dip in the expectations of further declines.

Do you recognise any of these?

- You avoid the opportunity of investing at the bottom of an investment cycle when prices are low
- You only review the annual performance of your investment as opposed to the performance over the last five years

Overconfidence bias

Overconfidence biases arise because we assume that we have a greater understanding of the markets that we actually do. We believe that we're able to predict events with a certain degree of accuracy and are confident about the probability of an incidence occurring. It's a miscalculation of subjective probabilities.

If you find yourself doing any of the following, you may be affected by an overconfidence bias:

- Buying and selling investments frequently as you believe you can time the market
- Failing to diversify (because diversifying is only for those who cannot predict the future)
- And a very typical one - going on a road trip without a map and cell phone data and refusing to stop and ask for directions!

Overconfidence can be even riskier when combined with a self-attribution bias which is the term used for investors which attribute success to their own skills and failures due to bad luck. This results in the danger of never learning from past mistakes.

Herding bias

A herding bias is our inclination to follow the masses, whether we actually believe in the groupthink or not. We take on the group mindset as we don't want to be outsiders and feel there must be some sense in the groupthink. It's dangerous as it makes us less likely to question the factors surrounding investment decisions.

The herding bias (along with the recency bias) explains bull and bear markets. When markets rise, we follow the masses, and keep buying and demand pushes prices up, and as markets fall we all sell, and the increased supply leads to further fall.

If you've done any of the following, there's a good chance you're affected by the herding bias:

- Moving more investments into passively managed funds following this trend in the US
- Selling bitcoin in fear of a further decline in value (having just invested in them a couple of months ago)

Understand yourself

We can't rid ourselves of these emotional biases as we're human, but we can commit to becoming more self-aware and being willing to analyse our thinking before making investment decisions.

Some of the best ways to improve self-awareness include:

- Taking advantage of the opportunity to discuss all your investment decisions with us at Gradidge-Mahura Investments so that we may assist you to maintain impartiality and make sound long-term decisions
- Keep records of your investment decisions and the emotional circumstances at the time and learn from your past behaviour
- Keep reading, learning and discussing current information with others and give equal weight to their opinions

Let's end with the valued words of Warren Buffet:

"If you can't control your emotions, you certainly can't control your money".