InvestmentInsights.com

Investment Academy | Behavioral and Philosophical

Behavioral Finance

Alan F. Skrainka, CFA
Chief Investment Officer

"We are going to the zone where the positive impact of the ESG buzz on prices is coming to the end of its cycle. Soon we will be at the stage where the relationship between ESG and performance will be negative as it [logically] should be."
— Abraham Lioui, Edhec Business School

Introduction

Behavioral finance explores how **human psychology and biases** affect investing decisions. As one guide explains, it is *"the field of psychology that studies how and why human biases influence financial markets"*. Even knowledgeable investors can go wrong: **"even when humans have all the facts, we can make mistakes, because it is difficult to remove emotions"**. In other words, emotional and cognitive biases are inevitable and can create predictable market inefficiencies.

Understanding these common biases can help investors recognize and avoid costly mistakes. Below we explain key biases in plain language with investing examples, supported by research. We then turn these insights into specific, practical steps investors can follow to improve their decisions.

Loss Aversion and Prospect Theory

What it is: Investors typically **fear losses more than they value equivalent gains**. In Kahneman and Tversky's Prospect Theory, a $100 loss feels roughly twice as painful as the pleasure of a $100 gain. That means losses loom larger on our minds than same-sized gains.

Example: Suppose you bought a stock and it falls by 10%. Loss aversion may make you cling to it to avoid "locking in" a loss, even if the company's prospects have soured. Alternatively, you might stay heavily in low-risk bonds to avoid any dip, but then miss out on growth. Morgan Stanley warns that being too focused on avoiding losses can leave your portfolio *"not growing enough to reach long-term goals,"* and selling out of fear during a downturn only "locks in" those losses.

Why it matters: Overemphasizing losses can leave portfolios under-powered or cause panic selling. If you treat every price drop as catastrophic, you may miss the market's rebound. A useful perspective is that **paper losses aren't real losses until you sell**. As one advisor puts it, *"when the market is down, you've only 'lost' if you sell in that moment"*. Keeping this in mind helps resist knee-jerk selling during volatility.

Action steps: Frame market dips as temporary volatility, not permanent disaster. Stick to your diversified asset allocation and use downturns as opportunities (for example, by rebalancing or buying more of quality assets on sale). Remind yourself of long-term goals (like saving for retirement) so that short-term swings don't derail you. In practice, this means having an emergency cash cushion (so you aren't forced to sell in a crash) and a long-term plan that you review calmly, rather than panic-selling at the first sign of trouble.

Overconfidence

What it is: Overconfidence bias makes investors **overestimate their own skill or information**. They may believe they can pick winning stocks or time the market, even though markets are largely unpredictable. Essentially, it's having an oversized ego about your investing ability.

Example: An overconfident trader might react to a few quick wins by trading more aggressively, thinking they have special insight. In reality, studies show this backfires: investors who trade most actively tend to earn *much* lower returns. For instance, one study found the 20% of individuals who traded most often earned only ~11.4% per year (net of costs), while the 20% who traded least earned about 18.5%[1]. In other words, frequent trading driven by overconfidence destroyed performance by roughly 7 percentage points annually!

Why it matters: Excessive trading (a common result of overconfidence) incurs high costs and poor timing. Investors may jump into volatile bets or switch strategies often, hurting returns. Morgan Stanley notes that overconfident people even think they can time the market, despite its randomness. History says: most cannot reliably beat the market by trading.

Action steps: Assume you **can't** consistently outguess the market. Limit trading frequency with explicit rules (e.g. set minimum holding periods or a trade budget each year). Consider using low-cost index or target-date funds instead of picking individual stocks. Periodically check your performance: if you're not beating a passive benchmark, that's evidence to dial back trading. In short, cultivate humility—make changes only when your long-term plan or clear evidence calls for it, not on a hunch.

Anchoring

What it is: Anchoring bias means fixating on a specific reference point (the "anchor") when making decisions. In investing, this could be the first price you saw, a past high, or any memorable number. Once anchored, people adjust too little in response to new information.

Example: Suppose you bought a stock at $50. If it falls to $40, you might irrationally wait until it recovers to $50, even if the company's outlook is worse. Or if someone boasts *"I doubled my money in crypto,"* you might anchor on that success story and assume similar gains are likely, ignoring the enormous risk it implies. Common anchors in media include headlines like "Stock XYZ hits record high." Morgan Stanley cautions that such anchors can mislead – *"the price your friend bought at is completely irrelevant"*. to your decision.

Why it matters: Anchors can distort valuation. If you ignore new data because you're stuck on an old price, you may hold losers too long or ignore bargains. Decisions should be based on current fundamentals and your own goals, not on arbitrary past figures.

Action steps: Challenge every anchor. Ask: *Why is this number significant to me?* Focus on objective metrics (earnings, cash flow, growth prospects) instead of past prices. For example, don't refuse to buy at $40 just because you "bought at $50"; instead compare $40 to the company's intrinsic value. By consciously dismissing irrelevant anchors and re-evaluating investments on up-to-date criteria, you make more rational choices.

Herding

What it is: Herding bias is following the crowd instead of your own analysis. When many investors act together, individuals often jump on the bandwagon, assuming others have special information.

Example: Classic bubbles illustrate this. In the late 1990s, many bought Internet stocks simply because everyone else was buying, not because profits justified the prices. More recently, “meme stock” runs were driven by social enthusiasm, not fundamentals. In fact, Morgan Stanley notes, *“the crowd is often wrong, and trends can be short-lived”*. (A famous experiment even showed people changing correct answers to match a unanimous but wrong group opinion.)

Why it matters: Riding herd can mean buying high and selling low. When the crowd’s mood turns, gains can evaporate quickly. If you join every popular trade, you risk being late in and early out of the market.

Action steps: Stick to your own analysis and strategy. If a stock or sector is surging, ask yourself *why* you’re buying beyond “everyone is doing it.” Check valuations and fundamentals first. Conversely, if panic is widespread, review actual data before selling. Using predefined rules helps (for instance, rebalancing or predetermined buy/sell thresholds) so you’re not purely following sentiment. In short: avoid chasing hype, and remember that contrarian discipline often pays off in the long run.

Confirmation Bias

What it is: Confirmation bias is the tendency to seek information that confirms your beliefs and ignore information that contradicts them. In investing, it means paying attention only to news that supports what you already want to hear.

Example: If you believe a stock will rise, you might read only upbeat reports and skip negative analyses. For instance, among ten headlines about a company, you might click only the five that say “Company ABC surges,” ignoring the five that warn of trouble. Morgan Stanley warns this can be dangerous: *“limiting yourself to information that confirms what you already think may cause you to miss important warning signs”*.

Why it matters: Ignoring dissenting information can leave you blindsided by risks. If you only listen to positive news, you won’t prepare for potential problems.

Action steps: Deliberately look for contrary viewpoints. For any investment idea, ask "What am I missing?" and read reputable bearish reports. Discuss your strategy with someone who disagrees. By considering opposing arguments, you ensure a more balanced view. This doesn't mean you have to change your mind, but it does mean you'll be making decisions based on a fuller picture.

Recency Bias

What it is: Recency bias is giving too much weight to recent events or trends. Investors may assume that the latest big move will continue, whether up or down.

Example: If the market has just rallied, you might think it will keep soaring; if it just crashed, you might believe the downtrend is permanent. Morgan Stanley notes that recency bias can cause people to *"buy near the top… and sell at the bottom"*. For example, after the 2008–09 crash many stayed out of stocks for years, fearing another collapse, and missed the rebound.

Why it matters: Chasing recent performance usually leads to bad timing. Buying because of last year's gains or selling because of last month's losses often locks in poor outcomes.

Action steps: Keep a long-term perspective. Look at decade-long charts or historical averages (e.g. U.S. stocks have averaged ~7–10% per year over many decades). Avoid rash moves based solely on the last few months. A disciplined rebalancing strategy (selling some of what's gone up and buying what's lagging) naturally counteracts recency-driven panic or euphoria.

Availability Bias

What it is: The availability bias (or availability heuristic) makes us judge the probability of events by how easily examples come to mind. Dramatic or recent stories loom larger in our minds than they should.

Example: Vivid news can mislead investors. If the financial media endlessly covers a few high-flying tech stocks, an investor might overestimate the likelihood of those stocks continuing to outperform. Quartr notes that hearing frequent news of stock gains may make people *"overestimate the ease of making money in the stock market."*. Conversely, nonstop headlines about disasters can exaggerate perceived risk.

Why it matters: Decisions based on standout anecdotes can misallocate capital. You might overweight popular companies just because they're in the headlines, or shun entire industries after a few bad stories, even if the overall statistics say otherwise.

Action steps: Balance stories with data. If media coverage is vivid, check objective stats. For example, after alarming news about a few bankruptcies, look up the actual default rate in that sector. Use broad indices and long-run data when making judgments. Remember that headlines are often memorable but not always representative of typical outcomes.

Status Quo Bias

What it is: Status quo bias is the preference for keeping things the same. In investing, it shows up as inertia—sticking with your current holdings just because they're familiar, not because they're still the best choice.

Example: An investor might never sell a poorly performing stock simply because it's been in their portfolio for years. Trustnet explains that this leads people to "hold onto certain stocks or asset allocations simply because they represent familiar choices, not necessarily because they are the most prudent". For instance, one might stay 100% in a savings account out of habit, even though inflation is eroding its value.

Why it matters: Blind inertia can hurt returns. Market conditions and personal goals change; a strategy that was prudent years ago might become suboptimal. If you never revise your portfolio, you may miss new opportunities or fail to cut losses on underperformers.

Action steps: Be proactive. Schedule regular portfolio reviews (e.g. quarterly or annually) to ensure your investments still match your goals and risk tolerance. Rebalance to your target allocation when it drifts. If a holding no longer fits, be willing to replace it. Automation can help—many brokerage plans will auto-rebalance or let you set periodic review alerts. Overcoming inertia is key: routinely ask yourself, *"Am I only holding this because it's familiar?"*

Putting It All Into Practice

Based on these insights, the practical takeaway is **planning and discipline**. Here are concrete steps individual investors can take:

- **Have a clear plan and stick to it.** Define your goals (retirement date, target returns, etc.) and an asset allocation (mix of stocks, bonds, etc.) suited to them. Automate regular contributions and rebalancing. A written plan helps prevent knee-jerk reactions to short-term events.
- **Use low-cost, diversified funds.** Broad index funds or ETFs spread risk across many assets. This helps ensure you're not derailed by any single bad bet and reduces the temptation to tinker. It also cuts fees: indeed, studies show that higher trading costs significantly drag down performance[1].
- **Limit trading frequency.** Less is often more. One study found the most-active traders earned about 7 percentage points less per year than buy-and-hold investors.[1] To avoid overtrading, set rules (for example, hold a stock for at least 6 months, or make no more than X trades per year). Often the best action is to do nothing.
- **Seek out contrary views.** To fight confirmation bias, deliberately read skeptical analyses. Ask yourself "What if I'm wrong?" and find reasons not to invest. Getting both sides of the argument makes your decision more robust.
- **Question your anchors.** Whenever a price or "target" feels important, challenge it. Remember that someone else's purchase price or a round historical high isn't a magic number for you. Make decisions based on your own valuation and circumstances.
- **Avoid chasing the crowd or hot trends.** If a sector or stock is hyped, pause and check fundamentals. When the market is euphoric, assume caution; when it's depressed, consider buying if nothing fundamental has changed. Set entry/exit criteria in advance so you don't trade purely on emotion.
- **Regularly review and adjust.** Don't leave your portfolio on autopilot (status-quo bias). At least once a year, rebalance to your target allocation and ensure each holding still fits your goals. Trim positions that have grown too large and add to those lagging, according to your plan.

- **Educate yourself on these biases.** Simply knowing these tendencies exist is powerful. Before acting, ask: “Am I doing this out of fear, greed, familiarity, or because everyone else is doing it?” Naming the bias often breaks its hold.
- **Use tools or advisors.** Consider robo-advisors or financial planners who enforce discipline. For example, robo-platforms automatically rebalance and stick to a chosen strategy, which can protect you from your own impulses.
- **Stay patient and long-term focused.** Most successful investing is a marathon, not a sprint. Keep long-term goals in sight. Patient, diversified investors who stick to a sound strategy generally outperform those trying to time short-term swings[1]

By following these guidelines, investors can mitigate the costly effects of behavioral biases. For example, research shows that controlling bias-driven trading activity can **boost returns** – the most active traders in one study underperformed passive investors by ~7% per year[1] In essence, using a data-driven, disciplined approach (rather than emotional reactions) is one of the most effective ways to improve long-term investing results.

Sources:

1. The Behavior of Individual Investors, Barber and Odean, University of California, Berkeley
2. Behavioral Finance, Understanding its Impact on You, Morgan Stanley

---

Disclosures:

assistants aided in improving the clarity, grammar, and overall readability of the text. All information presented has undergone rigorous human review, and editorial refinement. InvestmentInsights is responsible for final editorial oversight. Although we are committed to providing accurate, reliable, and unbiased information to help you make informed investment decisions and sources are believed to be reliable, accuracy and completeness are not guaranteed.

Model portfolios, mutual fund reviews, and ETF analyses reflect the views of the author at the time of publication. They are not tailored to any individual's financial situation, investment objectives, or risk tolerance. This content is illustrative in nature and should not be relied upon as a basis for making investment decisions.

Investing involves risk, including the potential loss of principal. Past performance is not indicative of future results. Investment returns will fluctuate, and investors may receive more or less than their original investment upon redemption.

ETF shares are bought and sold at market price (not NAV) and may trade at a premium or discount. Brokerage commissions and trading costs may apply. Diversification does not guarantee a profit or prevent loss.

Before investing, investors should carefully review the fund's prospectus, which includes information about investment objectives, risks, charges, and expenses. Prospectuses are available from the fund provider's website and should be read carefully before investing.

All information is provided "as is" without warranty of any kind. Although sources are believed to be reliable, accuracy and completeness are not guaranteed. Investment Insights.com does not offer personalized advice or establish a fiduciary relationship. Always consult a licensed financial professional before making investment decisions.

This content is intended for U.S. residents and may not comply with legal requirements of jurisdictions outside the United States.

This content is intended for U.S. residents and may not comply with legal requirements of jurisdictions outside the United States.

For questions about this site or to report concerns, please contact us directly.