The Impact Behavioral Finance Has On Your Portfolio

Learn how to escape the investment traps your brain sets for you.

Our brains regularly set little traps for us, emotional and psychological potholes that sometimes have very real costs associated with them.

Trap No. 1: Overconfidence

We trust ourselves, and for good reason. We think we know what we know. But in the investing world, that leads to overconfidence.

Being cocky also can lead to miscalculating the probabilities of good and bad outcomes, to overweighting an investment's potential upside and discounting the potential downside. It could also lead you to double-down on a particular security, throwing your asset allocation out of whack and possibly adding in more risk and volatility.

Red flags: If you ever find yourself saying things like, "Nothing could ever go wrong", "I believe it'll go forever" or "I know the company and I know the risks", it's time to check yourself. It may help to remember that every investment carries with it some risk and potential for losses.

Shatter the illusion: Many long-time employees and executives get tricked by overconfidence. They believe that they have enough knowledge of a company's fundamentals because they helped build it. That may be true, but does it make sense to tie up 40% of your portfolio in one position? There's a reason investment wisdom suggests diversifying a portfolio.

Trap No. 2: Mental Accounting

Mental accounting tricks your mind into compartmentalizing certain investments, based on something arbitrary like the fact that your grandfather gifted it to you. Favoring one investment over another can hinder long-term investors whose entire portfolio should be working together to manage risks and make headway toward established goals.

Red flags: If you find yourself saying, "But I love that stock", you may have a problem.

Shatter the illusion: "Don't ever fall in love with a stock; it'll never love you back." The cliché is actually sound advice. Counter the emotional pull of a winning investment with sell rules established in conjunction with your financial advisor.

Trap No. 3: Confirmation and Hindsight Bias

Confirmation and hindsight bias are the fun-house mirrors of investing, reflecting back a distorted view of reality. The first is a tendency to interpret information that reflects and confirms our preconceptions. The second makes us think that unpredictable events, in hindsight, were actually predictable.

Both mean that what we perceive as true isn't necessarily so. Our minds have a sneaky way of introducing those biases before we even realize it.

Red flags: Shrugging off negative news or data about a beloved company. Holding onto a stock even after receiving several sell signals.

Shatter the illusion: Being aware of these biases may not be enough to challenge them. You may need a trusted voice of reason – like a knowledgeable investment professional – to play devil's advocate before making a move based on just your own observations.

Trap No. 4: Benchmark Bias

This particular trick is marked by comparing your portfolio's rate of return to a broad market index. The goal of financial planning is to make progress toward your individual goals – and this part is key – without taking on excessive risk.

Red flags: "Why didn't I beat the S&P/TSX?" This feels like you're not keeping up with the Joneses, but it can also lure you away from the logic you used in making investment decisions in the first place.

Shatter the illusion: The measure of success is movement toward the end goal. If you're a long-term investor, what matters most is attempting to achieve steady performance over long periods of time, not the daily, monthly or quarterly gyrations of the benchmarks.

Trap No. 5: The Gambler's Fallacy

The gambler's fallacy lures you into perceiving trends or patterns where none exist, tricking you into taking action based on unsubstantial or faulty evidence. It's like when someone playing roulette lets it ride on red because the last three spins landed on red. The fact is the probability is still 50/50 with each spin. Yet, the allure of spotting a "trend" can be powerful.

You'll see investors chasing last year's winners or favoring a particularly "hot" money manager or asset class. You may even get lucky a few times, but chasing the next big thing can lead you to erroneous assumptions and a false sense of having the odds in your favor.

Red flags: "I'll know when to get out." No one has yet perfected market timing.

Shatter the illusion: Admit that you're vulnerable to the gambler's fallacy and seek out fundamental analysis of a security, independent of "noise" surrounding a particular investment's winning or losing streak.

Trap No. 6: Herd Behavior

Herd behavior is hardwired into the human brain. As social beings, we bow to pressure to conform and believe that so many people can't possibly be wrong. But that feeds bubbles. Usually, by the time everyone has heard about a trend, it's too late to capitalize on the upward momentum.

Red flags: A fear of standing out from the crowd or missing out on a trend. Buying high and selling low.

Shatter the illusion: Large institutions establish investment mandates, and their portfolio managers stick to the outlined strategy. Think like an institutional investor and weigh the merits of a potential investment's ability to further your long-term goals.

"Be fearful when others are greedy and greedy when others are fearful."
– Warren Buffett

Trap No. 7: Loss Aversion and Anchoring

Loss aversion delivers a particularly powerful psychological sting. It's the idea that we'd rather avoid losses than reap rewards. As humans, we hate losing. In fact, we regret our losses more than we enjoy our winnings. Loss aversion leads us to hold on to under performing stocks in hopes of one day making up for the declines.

Anchoring plays a part here, too. We establish certain subjective milestones in our minds. Once reached, we'll take action. But, focusing on a specific point of reference, like the price you paid for a stock or a stock's historical peak, could cause you to ignore a changing market to your detriment or keep a holding that needs to be excised from your portfolio.

Red flags: "I don't want to lock in a loss.", "I'll sell when it gets back to where I bought it." Because we spent money on something, we tend to keep it longer than necessary in the hope that it will recover.

Shatter the illusion: Let your portfolio do what it was built to do. Every year, something will win or lose, that's why you should be diversified with non-correlated investments.

Gaining Experience and Perspective

We're learning more and more about behavioral finance and the effects on individual investors. But it seems that adhering to a sound investment philosophy may be one of the best ways to avoid the pitfalls set by our brains. A diversified, balanced portfolio may beat market averages over the long term. That may seem boring, but it can be an effective way to attempt to meet your goals.

If you find yourself wanting – or needing – to take action out of hope, fear or regret, turn to your financial advisor to challenge you and remind you why you're invested the way you are. A trusted advisor serves as an educator, counselor and sounding board and can guide you to a blend of approaches meant to steady your emotions, as well as your portfolio.

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