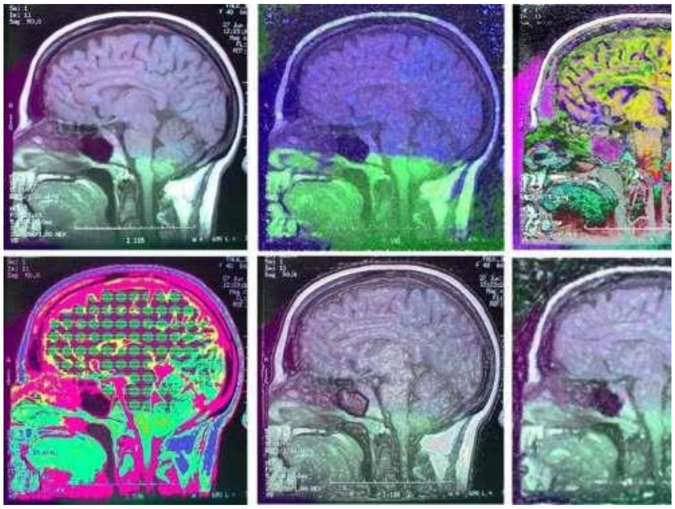
7 ways your brain makes you a terrible investor



Behavioral biases that drive investor decisions

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It doesn't matter how rational you think you are.

You have a brain, and the chemicals in your brain often force you to make irrational decisions. This affects everything from decisions you make in your love life to trades you make in your investment portfolio.

"Investors are 'normal,' not rational," says Meir Statman, one of the leading thinkers in behavioral finance.

Behavioral finance is the booming field of study aiming to reconcile the discrepancy between rational valuation and irrational market pricing. Top behavioral finance gurus you may have heard of include University of Chicago's Richard Thaler, Nobel Laureates Robert Shiller and Daniel Kahneman, and Credit Suisse's Michael Mauboussin.

With the help of Hersh Shefrin's "Beyond Greed and Fear," we compiled a list of the seven common behavioral biases that drive investor decisions. Read through them, and you'll quickly realize why you make such terrible financial decisions.

Investors believe they are awesome at investing

Overconfidence may be the most obvious behavioral finance concept. This is when you place too much confidence in your ability to predict the outcomes of your investment decisions. Overconfident investors are often under diversified and thus more susceptible to volatility.

Investors are bad at processing new information

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Anchoring

Anchoring is related to overconfidence. For example, you make your initial investment decision based on the information available to you at the time. Later, you get news that materially affects any forecasts you initially made. But rather than conduct new analysis, you just revise your old analysis.

Because you are anchored, your revised analysis won't fully reflect the new information.

Investors connect the wrong things to each other

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Representativeness

A company might announce a string of great quarterly earnings. As a result, you assume the next earnings announcement will probably be great too. This error falls under a broad behavioral finance concept called representativeness: you incorrectly think one thing means something else.

Another example of representativeness is assuming a good company is a good stock.

Investors absolutely hate losing money

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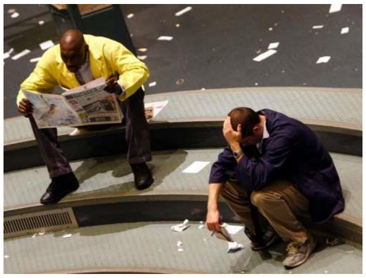
Loss Aversion

Loss aversion, or the reluctance to accept a loss, can be deadly. For example, one of your investments may be down 20% for good reason. The best decision may be to just book the loss and move on. However, you can't help but think that the stock might comeback.

This latter thinking is dangerous because it often results in you increasing your position in the money losing investment. This behavior is similar to the gambler who makes a series of larger bets in hopes of breaking even.


Investors have trouble forgetting bad memories © REUTERS/Joshua Lott

Regret Minimization

How you trade in the future is often affected by the outcomes of your previous trades. For example, you may have sold a stock at a 20% gain, only to watch the stock continue to rise after your sale. And you think to yourself, "If only I had waited." Or perhaps one of your investments fall in value, and you dwell on the time when you could've sold it while in the money. These all lead to unpleasant feelings of regret.

Regret minimization occurs when you avoid investing altogether or invests conservatively because you don't want to feel that regret.


Investors like to go with the flow © Flickr / Marc Dalmulder

Frame Dependence

Your ability to tolerate risk should be determined by your personal financial circumstances, your investment time horizon, and the size of an investment in the context of your portfolio. Frame dependence is a concept that refers to the tendency to change risk tolerance based on the direction of the market. For example, your willingness to tolerate risk may fall when markets are falling. Alternatively, your risk tolerance may rise when markets are rising.

This often causes the investor to buy high and sell low.

Investors are great at coming up with excuses
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Defense Mechanisms

Sometimes your investments lose money. Of course, it's not your fault, right? Defense mechanisms in the form of excuses are related to overconfidence. Here are some common excuses:

'If-only': If only that one thing hadn't happened, then I would've been right. Unfortunately, you can't prove the counter-factual.

'Almost right': But sometimes, being close isn't good enough.

'It hasn't happened yet': Unfortunately, "markets can remain irrational longer than you and I can remain solvent."

'Single predictor': Just because you were wrong about one thing doesn't mean you're going to be wrong about everything else, right?