New Investors: Avoid These 3 Harmful Cognitive Biases For Success

Description

An investing bias is an irrational preference that affects one’s investment decisions and outcomes. We unconsciously know what we’re doing isn’t for the best, but for one reason or another, convince ourselves that it is the right thing to do.

Having an investing bias distorts our thinking and prevents us from making the kind of cool-headed, scientifically driven decisions that smart investing requires. Instead of making an objective, rational decision on facts and evidence, we act emotionally off distorted or illogical patterns of thinking.

Today, I’ll be going over three pairs of common biases new investors (including myself at one point) typically have. Learning how to recognize and avoid them can boost your returns significantly.

Herding / FOMO

There’s a hot stock/fund out there everyone, from your friend group, family, and Reddit are just piling into. You can’t help but feel an urge to join them – to jump on the proverbial bandwagon.

This behaviour is called herding, and it plays off our desires to be part of a group and do what the crowd is up to. The second part, FOMO, means the “fear of missing out”.

Falling subject to herding / FOMO often causes investors to buy into pump-and-dump scams or overvalued stocks that inevitably crash down, leaving them with big losses. Just because everyone is in on it, doesn’t make it more likely to be right in the end.

Confirmation / Overconfidence

We all know that doing the research before you pick a stock is essential, but have you ever considered the quality and objectiveness of your research? It’s easy to get caught up in an echo chamber sometimes.

Confirmation bias is when you unconsciously seek out and give more credibility/weight to information that supports your investment. This means that you also tend to avoid or shun information that could discredit it.

Add a dash of overconfidence (“this stock pick is a sure thing! I’ll be able to retire early”), and you’ll encounter a nasty surprise when your stock pick collapses and loses a lot of value because of some very obvious red flags you ignored. Actively cherry-picking data that reinforces your investment theory won’t make it any more correct.

Recency / Survivorship

US tech stocks like the FAANG cohort have done incredibly well over the last decade. So it’s a no-brainer to just invest in those winners, right? A portfolio of FAANG has historically beaten the S&P 500, so why would it be different now?

This is an example of recency bias. We have a tendency to infer future outcomes from past performance and overweight their importance. However, there is no guarantee this trend will continue.

We also have a tendency to focus on the investments that did well, as opposed to seeing the often larger group of failures, called survivorship bias. An investor exhibiting both will likely gravitate towards buying stocks that outperformed in the past, but will likely underperform in the future.

The Foolish takeaway

Good investors are cool, rational, and mechanical. They stick to their investment thesis, consider contrarian views, and weigh evidence objectively. They have a forward-looking mindset and avoid succumbing to emotion. Understanding these investing biases can help you avoid them on your way to becoming a successful investor.

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