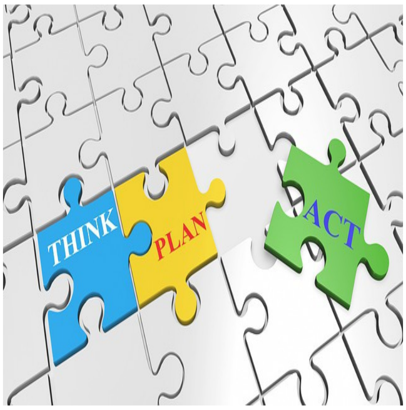

Are These Behavioural Biases Hurting Your Returns?

Description

Investopedia defines biases as human tendencies that lead us to follow a particular quasi-logical path, or form a certain perspective based on predetermined mental notions and beliefs. When investors exhibit biases, they fail to consider all the facts and can overlook evidence that goes against their initial opinion.

Cognitive biases are due primarily to faulty reasoning and could arise from a lack of understanding of proper statistical analysis techniques, information processing mistakes, or memory errors. Such errors can often be corrected or mitigated with better training or information.

In contrast, emotional biases are not related to conscious thought and stem from feelings, impulses, or intuition. Therefore, they are more difficult to overcome and may have to be accommodated.

Today, let's look at two common cognitive biases and determine if there are ways to overcome or mitigate these biases.

Confirmation bias

It occurs when investors tend to look for and notice information that confirms their beliefs, and they overlook or underestimate information that contradicts their beliefs. For example, if you are overly attached to a particular holding in your portfolio, you might only be looking for information that's favourable to that stock.

This can be dangerous for investors, as they can end up building a position in a bad investment by only focusing on positive news and ignoring negative information about the investment. This can also lead to the undesirable side effect of having a poorly diversified portfolio.

It is important to seek out contrary views and information to allow you to consider all the facts before making investment decisions.

Recency bias

This bias is the tendency to recall recent events more vividly and assign an outsized importance to these events. In other words, it takes place when you think that what's been happening lately will keep happening. For example, some people avoid flying immediately after seeing news reports of an airplane crash, even though flying is statistically, by far, the safest way to travel.

An example in the investment world is when investors think that the stock market will continue to go down after a correction or that the stock market will keep on rising after a bull market.

This can potentially have disastrous results for investors as they find themselves selling undervalued securities and buying overvalued securities. This accomplishes the complete opposite of what the investing 101 mantra "buy low, sell high" dictates.

How to mitigate biases?

In my opinion, the best way to mitigate or even overcome biases is to create rules to follow, such as choosing to invest in solid companies and having a long-term focus. An example of a great company that investors could buy today and hold for a long time is **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD).

It's impossible to completely eliminate behavioural biases when we make investment decisions, but I find that being mindful of their existence makes me concentrate on making rational investment decisions. I challenge you to scrutinize your own process the next time you make an investment decision and to try to identify and mitigate, as much as possible, your own biases.

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Author
pattyg2000