



Decoding Cognitive Biases: What every Investor needs to be aware of

Common human biases that investors should understand when it comes to investing is extremely important. These biases are ingrained in human nature, leading to tendencies to oversimplify, rely on quick thinking or exhibit excessive confidence in judgments, which may lead to investment mistakes. By gaining insight into these biases, investors may be able to make better decisions to help reduce risk and improve their investment outcomes in the long-term.

Numerous cognitive biases can affect how decisions are made. The key to mitigating these biases lies in recognising their presence, identifying when they might arise, and then either making appropriate adjustments or obtaining help to moderate their impact.

Below we focus on seven cognitive biases that might arise at various stages of an investor's investing journey.

1. **Herding:** The tendency to follow and mimic the actions of a larger group.
2. **Confirmation Bias:** The preference for information that confirms one's existing beliefs or hypotheses.
3. **Overconfidence Effect:** Excessive confidence in one's own investment decisions and abilities.
4. **Loss Aversion:** When the fear of loss is felt more intensely than the elation of gains.
5. **Endowment Effect:** Overvaluing assets because they are owned.
6. **Neglect of probability:** Disregarding the actual likelihood of events and often overemphasising rare occurrences at the expense of more probable outcomes.
7. **Anchoring Bias:** The tendency to rely too heavily on a past reference or a single piece of information when making decisions.

HERDING

The herd mentality occurs when people find reassurance and comfort in a concept that is widely adopted or believe by many others. In recent times, we have seen the herd mentality with the events that surrounded the GameStop stock event. Where many people saw the rise in stock prices and without proper investment research followed the trend of many others and invested.

This impacted a lot of investors who bought the stock due to the fear of missing out and the hype it created. We believe, to be a successful investor, you must be able to analyse and think independently. Speculative bubbles are typically the result of herd mentality. Herd mentality in investing can overshadow rational decision-making and could increase the risk of financial losses.

Investors need to recognise the feeling of pressure to conform to popular opinion or follow the crowd and instead consider conducting research and analysis before making decisions, as well as seeking alternative views to challenge the consensus.

Our investment process is focussed on deep fundamental research and analysis, backed by an investment team with many years of experience. Investors concerned they're succumbing to herd mentality could benefit from consulting with investment professionals and seeking financial advice which may assist in mitigating this bias and maintaining their investment strategy.

CONFIRMATION BIAS

Confirmation bias is the tendency to favour information that corroborates pre-existing beliefs or theories. In our view, confirmation bias can lead to significant errors in investing. Investors may develop an inflated sense of certainty when they encounter consistent evidence supporting their choices. This overconfidence can create an illusion of infallibility, with an expectation that nothing can go wrong.

To counteract confirmation bias in investing, we proactively question established norms and actively seek out data to

question our investment hypotheses. Our approach involves a constant 'inversion' of the investment argument to understand potential flaws in our reasoning. We make it a point to reassess our investment rationale, particularly in light of emerging data, and to rigorously test our presuppositions. At Magellan in-depth research is the cornerstone of our methodology.

OVERCONFIDENCE BIAS

Overconfidence bias in investing is where investors overestimate their knowledge, intuition, and predictive capabilities, often leading to poor financial decisions. This bias can present itself through various ways, such as excessive trading, under-diversification, and the general disregard for potential risks.

Investors with overconfidence bias tend to believe they can time the market or have the ability to pick the winning stocks better than most, which in turn may also result in overtrading and increased transaction costs. Overconfidence can also lead to a lack of proper risk assessment and analysis, as investors might underestimate the likelihood of negative events or industry dynamics affecting their investments.

An example of overconfidence bias occurred during the dot-com bubble of the late 1990s and early 2000s. Many investors were overly optimistic about the growth potential of internet-related companies. This led to inflated stock prices as more and more people invested in these companies without proper evaluation of their actual worth.

LOSS AVERSION

Loss aversion is where a real or potential loss is perceived as much more severe than an equivalent gain. The pain of losing is often far greater than the joy in gaining the same amount.

This overwhelming fear of loss can cause investors to behave irrationally and make bad decisions, such as holding onto a stock for too long or too little time. For example, an investor whose stock begins to tumble, despite clear signs that recovery is unlikely, may be unable to bring themselves to sell due to the fear of loss in the portfolio. On the flip side, when a stock in the portfolio surges, they may quickly cash out, not wanting to see the possibility of those profits disappearing.

When an investor clings onto failing stocks, departs with successful stocks too quickly and fear governs their investment decision, it's known as the disposition effect. It's a direct consequence of loss aversion, leading investors to make overly cautious choices that ultimately undermine their financial goals.

So, understanding this bias may help investors make rational decisions to grow their portfolios while managing risk effectively.

We believe investors would make better investment decisions if they understood their risk tolerance (the amount of risk they are willing to accept in order to achieve their investment goals) and took a disciplined approach to weighing up the opportunity cost between keeping an existing investment or not.

ENDOWMENT EFFECT

Closely related to the concept of loss aversion is the endowment effect. This effect arises when individuals place a greater value on items because they own them, as opposed to identical items that they do not own. It's a cognitive bias where ownership elevates the perceived value of an item beyond its objective market value.

For example, an investor may develop a strong attachment to a particular stock. It could be the very first stock they ever invested in, or they may favour the company for a particular personal

reason such as aligning with their values. If this stock begins to fall and financial experts are advising to sell, because of the value bias this investor has they may be unwilling to sell. The investor perceives the stock's value as greater than what the market dictates, purely because of ownership. It is a delicate balance that is needed to be able to determine between attachment and sound financial decision-making and can be challenging for some investors.

To help mitigate the endowment effect, investors should regularly review their portfolios and consider the help of a financial adviser. Establish clear, pre-defined criteria for selling assets, aligned with financial goals. Develop a detailed investment plan with specific financial goals, a well-defined investment strategy is crucial to prevent emotional decision-making. Understanding and focusing on long-term investment goals can also help in maintaining objectivity.

NEGLECT OF PROBABILITY

Humans often overlook or misjudge probabilities when making decisions, including investment decisions. Instead of considering a range of possible outcomes, many people tend to simplify and focus on a single estimate. However, the reality is that any outcome an investor anticipates may just be their best guess or most likely scenario. Around this expected outcome, there's a range of potential results, represented by a distribution curve.

This curve can vary widely depending on the specific characteristics of the business involved. For instance, companies which are well-established and have strong competitive positions, tend to have a narrower range of potential outcomes compared to less mature or more volatile companies, which are more susceptible to economic cycles or competitive pressures.

In our portfolio construction process, we carefully consider the differences in businesses to account for the various risks and probabilities associated with different outcomes. This approach helps us construct portfolios that we believe are better suited to navigate the uncertainties of the market.

Another mistake investors may make is to overestimate or misprice the risk of very low probability events. While it's true that 'black swan' events can occur, excessively compensating for these rare occurrences can be expensive for investors.

To seek to mitigate the risk of 'black swan' events, we include businesses in our investment portfolios that we consider are high-quality and long-lasting, purchased at appropriate prices. We believe these companies have a tight range of potential outcomes, reducing the risk of major losses from unexpected events.

ANCHORING BIAS


Anchoring bias is the inclination to excessively rely on a previous reference or a single piece of information when making decisions. Numerous academic studies have explored the impact of anchoring on decision-making. Typically, these studies prompt individuals to fixate on a completely random number (such as their birth year or age) before asking them to assign a value to something. The findings consistently demonstrate that people's responses are influenced by the random number they focused on prior to being asked the question.

Looking at a recent share price is a common way investors may anchor their decisions. Some people even use a method called technical analysis, which looks at past price movements to predict future ones. However, just because a stock's price was high or low in the past doesn't tell us if it's a good deal now.

Instead of focusing on past prices, we look at whether the current

price is lower than what we think the stock is worth. We don't let past prices influence our decisions. We also don't rely solely on the current price when deciding whether to research a new investment. We want to be ready with well-researched options so we can make smart decisions when prices drop below what we believe is their true value.

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