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Tame these behavioural biases to navigate stock market swings

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Recognize and manage your own behavioural biases, which can subtly influence your choices and even lead to unsound decisions.

Summary
Investors are often driven by their own behavioural biases, which can lead to poor investment decisions

Investment decisions—whether buying or exiting a mutual fund or stock after underperformance—require more than just assessing the fund manager, company, or investment theme.

It is crucial to also recognize and manage your own behavioural biases, which can subtly influence your choices and even lead to unsound decisions. *Mint* takes a look at the key biases that investors to be aware of.

Survivorship bias

Survivorship bias focuses only on successful performers, ignoring failures and leading to skewed conclusions. This can distort investment analysis by considering only surviving funds or companies, creating a false impression of overall performance.

"Simply looking at Sensex returns doesn't reveal how its constituents have fared over the years. Even blue-chip Sensex stocks have faced steep corrections, been removed from the index, and faced bankruptcy. People often focus only on the survivors, overlooking those that didn't make it," pointed out Devina Mehra, MD and chairperson of First Global.

Within the mutual fund space, several small-cap funds have been merged with other funds of the same fund house, due to their poor performance.

Confirmation bias

Confirmation bias is the tendency to seek out information that confirms one's pre-existing beliefs while ignoring or discounting contradictory evidence. This can lead to skewed decision-making, reinforcing existing viewpoints.

“Confirmation bias occurs when people selectively collect data and focus on facts that support their already-decided views. They rationalize any contradictory data or arguments to fit their perspective," said Nimesh Chandan, chief investment officer of Bajaj Finserv AMC.

"People often look only for data that confirm their view, for example picking up a trivial news item that favours their investment decisions," he added.

Anchoring bias

Anchoring bias is the tendency to rely too heavily on the first piece of information encountered (the "anchor") when making decisions. This can lead investors to make judgments based on initial values rather than adjusting adequately for subsequent information.

For example, the anchor point can be a recent high or low of the stock. Mehra explained, "Just because an investment has fallen by 90%, doesn't mean it can't still fall by another 90%. A stock running up after a steep correction in short term and then dropping from its highs doesn't mean it is trading at attractive valuations."

“People often fall prey to anchoring bias, where they fixate on specific reference points. For example, someone might anchor to a company's 52-week high or a six-month price, thinking, "It has gone up so much now; I won't touch it," Chandan said.

"People tend to anchor to past prices or growth rates. If a company has consistently received high valuations, they assume it will always deserve high valuations. Similarly, if a company or fund category has shown 30% growth over the last two years, they believe it will continue at the same rate. This is why many assume small-cap stocks, which performed well in recent years, will yield similar returns in the future," Chandan added.

Recency bias

Recency bias is the tendency to overemphasize recent events, leading investors to prioritize short-term trends over long-term fundamentals.

In the financial year 2023-24, mutual fund investors jumped onto the small-cap bandwagon with funds in this category seeing record investor flows of ₹40,188 crore.

With so much investor flows chasing small-caps, market regulator Securities and Exchange Board of India (Sebi) recently raised concerns of a bubble forming in the segment and asked fund houses to do stress-tests on their small-cap schemes.

Endowment bias

Endowment bias is the tendency to value an asset more highly simply because you own it, leading to irrational attachment and potentially poor investment decisions.

Behavioural finance experts Daniel Kahneman, Jack Knetsch, and Richard Thaler conducted a 1990 experiment with US university students to study endowment bias. Participants given coffee mugs valued them higher than those who didn't receive one, demonstrating that simply owning an item increases its perceived value.

“The extreme case of endowment bias is that you fall in love with your investment. You end up with an emotional attachment with your investment. It can be a stock, a mutual fund or any investment for that matter. Your reasoning could be my father had bought it or I have held it for five years and it has given so much return in the past, how can I sell it now. It need not even be a loss-making position," says Mehra.

Endowment bias explains why 'hold' ratings exist for stocks, she adds. "If you wouldn't buy a stock now, there's no reason to hold it. On TV, we often see queries like, 'I bought this stock at this price and have held it for X years, what should I do now?' The price you bought it at and how long you've held it don't matter. You need to assess if the stock is worth buying today," Mehra says.

Loss aversion

Loss aversion is when one prefers to avoid losses over potentially getting equivalent gains. Simply put, the pain of losing money in an investment is psychologically more impactful than the satisfaction of making money on an investment.

This can force an investor to hold onto losing investments for too long in hopes of breaking even, rather than accepting a loss and reallocating funds to better opportunities.

For example, you invest in an infrastructure-themed fund, expecting strong performance from infrastructure companies. However, the fund underperforms, resulting in a 20-30% loss. Instead of reallocating the money to a diversified equity fund with a solid track record, you hold onto the underperforming fund, to avoid realizing the loss. This is how loss aversion can hinder your investment decisions.

Sunk cost fallacy

The sunk cost fallacy is similar to loss aversion as both prevent investors from booking losses. However, the key difference lies in the reasoning: with sunk cost fallacy, the reluctance to sell stems from the belief that too much money and effort have already been invested, making it hard to let go despite ongoing underperformance.

Attribution bias

Attribution bias is the tendency to attribute successes to personal skills and efforts while blaming external factors for failures.

"When you ask any investor how much of your performance you attribute to luck and how much to skill, you'll often hear them say, 'I am brilliant; see how well I have done.' They attribute success mainly to their skills," Mehra explained.

This perspective can lead to overconfidence, as investors believe their decisions are solely responsible for positive outcomes, ignoring the role of luck.

However, when their portfolios underperform, the narrative shifts. "If the market or your portfolio goes through a period when things don't do so well, then there are lots of people to blame. It can be a political thing, central bankers, stock operators, or company management," Mehra noted.

This external attribution for failures prevents investors from learning from their mistakes and improving their strategies.

The reality is that both successes and failures contain elements of luck. "In both successes and failures, there is an element of luck. By managing risks, you can just control the negative impact of your bad luck or even poor skills, in some cases. Even with the best decision-making process, some of your bets will not go well," Mehra said.