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Avoiding Irrational Investing to Keep Your Goals On Track

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Dynamic Portfolio Perspectives: Understanding How Investors Can Be Their Own Worst Enemy

Traditional financial and economic theory—such as Modern Portfolio Theory—holds that investors make decisions based on rationality, considering a wide variety of information as part of that process.[1] However, behavioral finance tells a different story: investors are inherently *irrational*, falling prey to many behavioral biases that have the potential to wreak havoc on their portfolios and derail their progress towards meeting their financial goals.[2]

In fact, the most common biases amongst affluent investors are *availability* or *recency bias*, which is present in 88% of those surveyed by Cerulli, and *confirmation bias*, which is present in 78%.[3] More on these later. For investors and their clients, maintaining the objectivity necessary to counter this potentially irrational behavior is crucial. Otherwise, investors may end up becoming their financial success' own worst enemy.

When investors work with a financial advisor to establish, create, and implement a financial and investment plan based on their unique goals, both parties in this relationship have a guiding star by which to evaluate ongoing financial and investment decisions. But this might not be enough, which is why both investors and their advisors need to understand the most common investor biases and their potential negative impacts to successful outcomes.

The final piece is using logical reasoning to counter those biases. For both investors and their advisors, a strong relationship built on trust can be a powerful asset when situations arise where irrational behavior may take hold. This blog post will demonstrate to both investors and their advisors how to avoid potentially problematic behavior that might damage otherwise successful investment journeys.

Meet the Most Common Investor Biases

While there are many investor biases, here are five of the most common:

1. **Loss Aversion:** The belief that losses are more significant than gains can make investors wary of investment risk.[4] Losses—or the prospect of losses—are internalized *twice as intensely* as wins or the potential for wins.[5]

2. **Recency or Availability bias:** The tendency to make investment decisions based on recent events and the most available information can lead investors to avoid risk after market downturns and embrace risk during market upturns.[6]

3. **Familiarity bias:** The belief that known or familiar investments are preferable to unknown or unfamiliar investments can lead investors to avoid alternative investment options.[7]

4. **Herd mentality bias:** The tendency to base investment decisions based on what peers are doing can bias investors towards hot or trendy investments.[8]

5. **Anchoring bias:** The inclination to fixate on a specific piece of information when making investment decisions, which can lead investors to assign an arbitrary, unfounded value to an investment.[9]

Counter Biases and Irrational Behavior

Information that leverages the advisor-client relationship can be helpful in countering investment biases. An investor, for example, might want to buy a hot stock such as Nvidia. Perhaps one of their friends or colleagues is boasting about all their investment gains from a situation like this. However, if such an investment is contrary to the investor's stated investment goals, the financial advisor can remind them about their goals and how their already-established investment strategy is designed to achieve those goals.

When investors are committed to their expressed goals and those are baked into their investment strategy, the financial advisor can more easily persuade them to avoid the hot or trendy investments based on herd or recency biases. Sometimes, it even may be of benefit for advisors at times to take investors to the "edge of the cliff" - illustrating how a significant deviation from a well-designed plan could potentially negatively impact their future and undo years of disciplined, intentional execution. Helping investors envision the potential negative long-term effects of a short-term, emotional choice can be an effective grounding exercise.

Educating investors on potential biases is another tactic advisors can use to steer them away from potentially bad investment decisions. Because biases tend to operate on an unconscious level, many investors aren't aware that these unseen forces are influencing their behavior. Working with their financial advisor, investors can leverage the information in this article to open a conversation about biases to inform your clients how these work—potentially before they are in the clutches of one of these biases.

Emphasizing a long-term perspective helps investors take a broader approach to their investing. Helping investors understand that volatility is a short-term rather than a long-term problem and that investing fads come and go assists them in overcoming their biases. From the very first meeting with an investor, their financial advisor can set expectations about weathering the market ups and downs together over your lifelong relationship. Advisors can also consistently reinforce these expectations in client meetings, which then goes a long way to deterring instances of investor rationality drift.

Finally, when financial advisors can demonstrate to investors that their process-driven investing methodology supports a logical, systematic approach, this guidance reduces the potential for investing based on emotions or biases. When investors understand that their advisor's approach is intentionally designed to take uncertainty out of the picture as much as possible, they may be less likely to react emotionally and let detrimental biases creep in which reduces the possibility of their desired outcomes.

Build Trust

In the long run, investors are less likely to push back against investment plans and strategies when they trust their advisor. A consistent approach that is based on listening and transparency not only builds trust, but also creates opportunities for investors to share their hopes and fears and work with their advisor to integrate those into their personalized experience.

Sources

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As always, Dynamic recommends staying balanced, diversified and invested. Despite short-term market pullbacks, it’s more important than ever to focus on the long-term, improving the chances for investors to reach their goals.

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