How to Make Better Investment Decisions
by Understanding Bias

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Investors are often subject to behavioural biases that can lead to flawed decisions and choices. Being aware of these biases – and understanding how they arise from your background and life experiences – can help you make better investing decisions and help achieve your financial goals.

When we make important decisions about the future, we start with the information and data available to us now and rely on our experiences, situation, and intuition to come up with the best possible answers. When we don't have the right information up front, or place too much weight on the wrong factors, decisions may not work out as well as we expect.

Economic environment, market movements and bias

The recent market uncertainty and economic environment may be leaving investors feeling more insecure and less confident with their investments. It would be nice if our investments grew at a steady, predictable rate over the long term. Unfortunately, markets go up, go down and sometimes stay relatively unchanged. How investors react to these changes depends considerably on the investment approach they choose.

A quantitative analysis examined why many investors do not achieve the investment returns they expect, and noted that investment results depend more on investor behaviour than on the way their investments perform.[1] Benjamin Graham, an investor and professor of finance who influenced the investment strategies of Sir John Templeton, Charlie Munger and Warren Buffet, said that the investor's chief problem – and even their worst enemy – is likely to be themself.[2]

How each of us works through our investment decisions and the emotional ups-and-downs that result from changing market values depends largely on our behavioural biases. When markets are going up, we may have a tendency to buy in, and when they are in decline, fear can lead us to premature selling.

In addition to ***confirmation bias*** (looking for information that confirms our pre-existing beliefs), there are other biases that negatively impact investor behaviour.[3]

These include:

Attention bias – companies and products that are mentioned more frequently are favoured by investors.

Home bias – the tendency to purchase investments in companies that are locally known or recognized.

Anchoring bias – basing future investment decisions on non-fundamental information, such as the price at which a security was initially purchased.

Hindsight bias – a mistaken belief that past results were obvious and could reasonably have been predicted.

Fear of missing out ("FOMO") – worrying about not being part of a positive investment trend bias.

Disposition effect bias – refers to a tendency to label investments as winners or losers. Disposition effect bias can lead an investor to hang onto an investment that no longer has any upside or sell a winning investment too early to make up for previous losses.

Representativeness bias – the belief that results obtained in the short term will continue into the future.

Investment professionals develop client portfolios based on each client's investment objectives, time horizon and risk tolerance, thereby trying to minimize the downside impact that these biases may create. Removing these biases from investment decision making will help deliver better long-term, risk-reward outcomes for your investment portfolio.

Diversification is important

Ensuring that you maintain a well-diversified portfolio across asset classes is the best way to reduce the impact of bias and market volatility.

Through diversification, you can reduce many bias in your investing, including:

- Owning a greater variety of securities helps to reduce attention bias.
- ***Home bias*** can be reduced by specifically including regional representation beyond locally known companies.
- ***Disposition bias*** can be addressed by looking at how the portfolio functions as a whole so that selling a single poor-performing security is less of a concern.

Follow a wealth planning strategy

The many reasons why we choose to invest our savings can be very personal. We often invest to be able to afford a comfortable retirement lifestyle. We also invest for goals such as home ownership or improvement, buying a car, a special vacation or to help children or grandchildren attend college or university.

Including all of your goals in a well-constructed wealth plan allows you to have a better idea of how much you should save, and how your investment choices can affect how these funds can grow. Depending on your current investments and your ability to save, your financial goals may be on the right track or have already been attained by following your wealth plan. When this happens, the need to earn a specific return may be reduced, allowing the focus to shift from actively seeking growth to risk reduction, in order to preserve your investments for your long-term personal goals.

A wealth plan is designed to balance your ability to save with the investments that you make to achieve your personal goals. While the return that you earn on your investment portfolio is always important, investing is the means to achieving your goals, and returns should not be the goal itself. Focus on your long-term personal goals, rather than the regular movements of your investments. Doing so will make it possible to address ***FOMO bias***. When a plan is on track it is easier to be more confident about your financial future.

Reducing bias

Working with a financial professional is a great way to reduce the negative impact that personal biases can have on your investment portfolio and your ability to reach your personal financial goals.[3] Furthermore, working with a financial professional and having a plan can prevent some of those biases from creeping in when information is complex, or decisions involve risk or uncertainty.

Confirmation bias is best addressed by looking for, and considering alternative scenarios or options. A financial professional can help by explaining differing investment points of view and by sharing information and research from a variety of sources. Looking at alternatives to your initial investment beliefs may allow you to be more objective.

Attention bias limits investment opportunities because the options that are immediately apparent are preferred. Maintaining a well-diversified portfolio that explicitly includes a wider variety of investment options ensures that your investment choices are broader and more balanced.

Home bias is similar to attention bias in that investment alternatives that are familiar and local are given priority. When considering investments from another geographical location, industry or sector, your financial professional can help you to take advantage of other opportunities. Financial professionals can help you learn about different investment options and help with putting these options together in the broader context of your personal wealth plan. Adopting a broader portfolio approach also helps to reduce investment risk. This is especially important if your investment portfolio is disproportionately represented by companies and industries that are closely located and very familiar to you.

Anchoring bias often results in focusing on a factor such as the initial purchase price which is not always relevant to the future performance of an investment. Focus instead on the current prospects for an investment to help determine how best to move forward. A financial professional can provide perspective and help evaluate investments as they have resources and experience to do this analysis. In this way emotions about movement relative to initial purchase prices will become less of a factor.

Hindsight bias, looking backwards to learn from your investment history, is a very important tool for your future success; believing that past results were easily predictable should be avoided. The objective voice of a financial professional can help you put past investment decisions in their historical context.

Fear of missing out bias, as there are so many investment options available, choosing those that are appropriate in your circumstances requires being selective. This means that not all opportunities should be acted on. Working with a financial professional will help you to find the investment alternatives that work for your personal situation, and are best suited to your specific goals; balancing your investment objectives with your risk tolerance, liquidity needs and time horizon.

Disposition bias can be reduced by thinking about when to sell a security after making the original purchase decision. Within a well-constructed portfolio, these decisions have to be made on a regular basis as newer investment ideas and strategies replace older ones that have had their day or helped achieve your objective. A financial professional can work with you to assess the need to make changes to keep your investment portfolio on track to meet your personal goals.

Representativeness bias often manifests when chasing a long-established investment trend. Working with a financial professional to look at future prospects for investment choices is wise because past performance is not necessarily a good indicator of future results.

Seek advice

To save and invest effectively, it is important to overcome the behavioural biases that influence rational decision making. A financial professional can keep you focused and on track with your financial goals by addressing these biases that you may not even realize are influencing your investment decisions.

For more information, please speak with your BMO financial professional.

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[1] DALBAR's 22nd Annual Quantitative Analysis of Investor Behaviour. DALBAR, Inc., 2016. 2016DalbarQAIBReport.pdf

[2] A Note on Benjamin Graham. Zweig, J. Jasonzweig.com, August 3, 2004. jasonzweig.com

[3] Behavioral finance: The psychology of investing. Hens, Dr. Thorsten and Meier, A. Credit Suisse, 2015. creditsuisse.com

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