# Five Ways our Brains Make us Bad Investors

If only I invested earlier. If only I sold sooner. "If only I..." are three words that haunt every investor. Thoughts like these tend to enter your mind when you realize you could have made a lot of money – or spared yourself a lot of pain – if only you had arrived at an investment conclusion just a little bit quicker.

Investing can be tough, but investors often make the job harder on themselves by letting their brains get in their way. Even when people have all the information they need to make wise investment decisions, their thoughts often tell them to do the opposite. Why? Extensive research into behavioural finance suggests it's because we have a hard time letting go of our biases. The theory is based on the idea that investors don't always act rationally, have limited self-control and aren't consistent in their decision-making. It's human nature.

The problem is that human nature can cause people to make bad investment decisions which, in turn, can negatively impact their short- and long-term financial goals. To battle back against your brain, you need to understand how cognitive biases influence us and recognize them before you start investing.

Here are five common behavioural biases that can lead to bad investment decisions:

### 1. Loss aversion

You may know that stomach-churning feeling that comes with losing money on a stock? That pain sometimes seems to hurt more than the joy of seeing your portfolio rise. There is a term for this feeling: loss aversion, and it can cause you to make irrational decisions, such as panic-selling investments that can throw off your financial plans.

Consider what happened in March 2020, when investors sold their stocks en masse, fearing the economic fallout from the initial pandemic lockdowns. The markets bounced back within weeks and, within months, reached new highs, rewarding those who stayed calm and held on.

Loss aversion can also drive you to sell your winning stocks for quick returns even when there are signs the market can climb higher, and hold on to your losers, hoping they'll move higher again. It can also prevent you from taking any risks, which can stunt your portfolio performance over the long term.

### 2. Herd mentality

There's nothing like news of a hot stock or sector to rally investors into buying more. It's called herd mentality and it happens if you decide to follow the crowd or market buzz around an investment without asking questions or doing your own research.

Examples include the "meme stock" frenzy during the early days of the pandemic and the cryptocurrency craze in more recent years. While joining the herd can lead to huge gains in the short term, many investors ultimately lose out when they jump on bandwagon investment decisions.

That's why it's important to do your own research and consult with your financial professional before selecting which stocks to buy and determine how much, if any, of those investments are suitable for your portfolio. The right answer will always depend on your risk tolerance and short- and longer-term investment goals.

### 3. Confirmation bias

Have you ever felt unsure about a purchase or personal matter and sought validation from someone you know who shares your perspective? We all do. It's called confirmation bias. It's when we actively seek out, interpret and retain information that aligns with our beliefs. It makes us feel better.

Seeking approval from like-minded people can help you make decisions, but it can also create blind spots. When you only focus on what you know or believe, you risk missing contradictory information that could negatively (or positively) impact your portfolio.

Confirmation bias has also been known to cause some investors to become obsessed with a few companies or investment types. When this happens, your portfolio could become less diversified, which could mean you're exposing yourself to too much risk – or too little – depending on your investment needs and goals.

**4. Overconfidence**

When you're starting a company or growing your wealth, you need to have a lot of confidence in your decisions – but overconfidence can be costly. If you've ever driven to a new destination without consulting a map, only to end up lost, chances are you've experienced overconfidence bias. Some investors can have the same self-assurance when wading into a stock or a sector, leading them to take unnecessary or even excessive risks.

While successful investing may require some hubris, it's usually the result of doing your due diligence, and consulting with your financial professional to examine a stock's fundamentals, the sector's health and any broader macro-economic trends that may impact its performance.

**5. Anchoring**

Many of us prefer the path of least resistance, so when we hear or read something that sounds convincing, we'll rely on that single bit of information to make a decision. It's like agreeing to go to a movie because you like a certain actor, without knowing anything about the plot.

The same thing happens when you're investing, although the consequences can be much bigger than potentially watching a bad flick. For investors, this trait is known as "anchoring bias." For instance, you might invest in a stock based on your first impression of their product, without taking the time to see how well the company's managed.

## How to avoid being a victim of bias

Chances are, you've experienced some of these biases in your life at one time or another. While the tricks our brains play on us don't mean portfolio disaster, being aware of them can make you a better investor.

Ultimately, these biases can influence your decision-making. To overcome them, you have to be willing to challenge your own decisions and actively seek out information and financial advice that contradicts your view of a potential investment. If you still like an investment, then this effort will help you gain confidence in your decision.

For many, the best way to avoid being overcome by our cognitive biases is to work with an experienced financial professional who can help keep your emotions in check and your investments on track.

It's still important to ask questions, but you'll have someone in your corner helping you make the hard decisions to keep you on track.

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

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