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Financial Insights

from Quinn+Cardy Wealth Management
of BMO Nesbitt Burns

The Psychology of Investing

Why do investors sometimes fall into the trap of buying high or selling low? Why do many of us procrastinate in saving for retirement, despite knowing its importance? Our brains are hardwired to sometimes make decisions that aren't always logical.

After the stock market crash of October 1987, a day in which equity markets fell 20 percent despite having no rational economic explanation, economists started to critically rethink their views about the fundamentals of economics. This acted as a springboard for the field of behavioural economics, which linked psychology with economics to show that human behaviour can have significant effects on economic decision making.

Behavioural economists have determined that cognitive biases often prevent individuals from making the best decisions. This is because our brains operate in two cognitive states: automatic and reflective. Our automatic system is uncontrolled, fast and unconscious. Our reflective system is controlled, effortful and deductive. Cognitive biases occur when the automatic system, often influenced by the current environment, dominates the reflective system. This is why going grocery shopping while hungry can lead to unhealthy food choices: our reflective system is easily overridden by a state of hunger.

In investing, human emotion can often drive these behavioural biases and cause us to make decisions that may not be in our best interests. "Herd behaviour," the tendency to follow the actions of a larger group, may cause investors to buy or sell due to pressure from others who are doing the same. "Recency bias" causes investors to believe that recent patterns or events in the markets will continue into the future. "Confirmation bias" suggests we put more emphasis on information that agrees with what we believe, discounting opinions and data that disagree with these beliefs.

Chart: An Excerpt from the Cognitive Bias Codex

Source: Visual Capitalist, attributed to designhacks.co; www.visualcapitalist.com/every-single-cognitive-bias/

In fact, according to scientists there are 188 known cognitive biases that can lead us astray from making rational judgments. The visual above shows just a handful of the complete list of biases as published on visualcapitalist.com. The full infographic, found at www.visualcapitalist.com/every-single-cognitive-bias/ presents an interesting look at how our brain can sometimes work against our better judgment.

The good news? With a bit of effort, we can learn to control these behaviours. Some of the most seasoned investors have trained themselves to avoid emotional impulses. We can also integrate different techniques into our investing programs, like regularly rebalancing portfolios, using managed products to put buy and sell decisions in the hands of experts, or incorporating systematic saving or investing programs to avoid market timing.

Most importantly, don't forget the influence that human behaviour can have on investing and plan ahead before it can have an impact. This may include sticking to your wealth and investment plan during volatile times or avoiding the urge to react to social and media pressure. And, remember, we are here to help you to temper these biases as we work with you towards achieving longer-term success.

Quinn+Cardy Wealth Management
of BMO Nesbitt Burns

1 First Canadian Place
38th Floor, P.O. Box 150
Toronto, Ontario M5X 1H3

Toll Free: 1-800-263-2286
Fax: 416-359-5346
www.quinncardy.com

BMO Private Wealth

Quinn+Cardy Wealth Management
BMO Nesbitt Burns