Behavioral Biases in Investment Decision Making

Author Name

College Name

Date

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The investment decisions play a central role in determining success of individuals and organizations in the economy by shaping the financial markets. Of course not, investment decision is not necessarily founded on a rational decision-making or pure financial analysis. Behavioral biases affect a large number of investors causing them to make suboptimal. The causes of these biases are psychological ones that cause the individual to lose judgment and make decisions on the basis of their emotions or erroneous thinking ability and not on the ability to make judgments on the basis of sound financial principles. Overconfidence bias, loss aversion and herd behavior are some of the most widespread biases in the field of decision-making when it comes to investment decisions.

Overconfidence Bias

Overconfidence is one of the most widespread biases in making investment decisions. Investors tend to assume they know or can forecast the movements of the market. The also unfair bias may result in a too big gambling behavior where overconfident investors may think that they can forecast the future with absolute certainty. Indicatively, an investor may be holding a poorly performing stock because he or she believes in it and thinks the stock will perform better despite market dynamics and trends. Research has revealed that the level of overconfidence bias is more pronounced with the individual investors and thus they tend to trade more, therefore, decreasing their overall returns because of transaction costs and poor investment decisions (Barber and Odean, 2001).

Loss Aversion

Loss aversion is defined as a psychological phenomenon in which investors experience the agony of losses more than the joy of making profit. This bias leads investor to keep losing investments too long in their hope of avoiding the realization of loss even where it might be more effective to reduce their losses and redirect their resources. This act may deprive investors the chance to make rational decisions and miss an opportunity to make a profit. According to research conducted by Kahneman and Tversky (1979), loss aversion, to a large extent, is embedded in the human psyche and thus is one of the strongest biases in influencing decision-making in many situations, including investing.

Herd Behavior

Another potential bias that is prevalent in investment decisions is herd behavior. This happens when investors act on the direction of a bigger group by taking actions as opposed to acting independently of their own research. It is evident in stock market bubbles whereby when an asset or stock starts increasing in value the people jump into it because of the fear of being left behind (FOMO), not looking at the underlying fundamental basis of the investment. The best examples of how herd behavior can lead to asset prices becoming unsustainably high to the point of market corrections occurring are the dot-com bubble of the late 1990s and the housing market crash of 2008. The need to get social approval and the fear of being left out in a good business normally motivates the move towards herd behavior.

Reducing the Behavioral Bias

Although it may not be easy to do away with behavioral biases, investors can do something to minimize the effect. A good approach entails having a strict discipline in investing, as well as creating an investment plan that is clearly set and founded on long-term objectives and not emotions that are short-term in nature. Also, choices of investments must be diversified, and it is possible to minimize the impact of individual biases through not over-committing to particular asset class or stock. It may as well be of benefit to professional investors to seek advice of financial advisors in a bid to have a clear picture of his decision to invest.

To sum up, biases related to behavior are very strong in investment decision-making and they tend to make the choices suboptimal. Herd behavior, overconfidence and loss aversion can be some of the problems that can mislead the judgment of an investor and as such, it is necessary to identify such trends and proactively implement measures to counter it. In this way, the investors will be able to make their decisions more reasonable and improve their financial performance over the long term.

References

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