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DIY Investing:

A Guide to

Behavioural Finance

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An introduction to behavioural finance

Imagine the scenario.

You're an avid football fan and you've managed to get a ticket to watch the World Cup Final. You've paid £100 for the ticket, but a friend offers you £200 for it (assuming that you're legally entitled to sell it on). You politely decline. A ticket tout offers you £500 for it. You still say no. When you're asked just how much compensation you'd need to part with that ticket, you struggle to come up with a number less than a huge, life-changing amount. And even then, if you took the money, you feel you might still have regrets.

Welcome to our series on behavioural finance. Behavioural finance (part of the broader field of behavioural economics), is the field of study that seeks to explain situations like the above. The situations where real people make real financial decisions that might not be easily explained or predicted by traditional economic theories.

For the next ten chapters, we'll be looking at a different aspect of behavioural economics every week as a way of examining just how much our decisions can be influenced by factors other than the cold, hard calculations we might think we're making as informed investors.

We are all prone to biases and emotional thinking. It's part of being human. These are not 'problems' we can 'solve' as such – behavioural economics rests on the recognition that we're all only human after all – but having an awareness of them can certainly help us in our approach to investing (and life in general).

In order to give some of the key concepts substance, and in an attempt to bring the theory to life, we've considered areas where the biases manifest themselves in real-life decision making.

The Sphere of Behavioural Economics

Until a number of economists and social scientists mounted a challenge to traditional and established thinking in the mid-1970s, **established economic theories didn't offer a way to take human behaviour into account**. Broadly speaking, economic theories were based on the assumption that in any given situation humans make rational, economically-sophisticated choices with all the relevant information to hand.

As a simple example, in the world of the traditional economic theorist, the holder of the World Cup ticket in the above example would accept one of the offers to buy it above face value, because it makes clear economic sense to do so. By their reasoning, it would be a sound and successful economic exchange and a rational decision that would lead to an increase in the seller's total wealth.

A handful of revolutionary economists and psychologists argued that it's not quite as straightforward as this. They believed that traditional theories could only tell part of the story and that if we wanted to understand more accurately how we make financial decisions we would need an approach that acknowledges the very human-ness of humans.

Our World Cup ticket dilemma is just one example of the vast area that behavioural economics covers. It exists at the intersection between economics and psychology and looks at the behaviours, biases and beliefs that we all carry around with us and employ when making financial choices. It acknowledges the life experiences we all bring to bear on every decision we make, often in situations where we don't have all the information to hand but need to make a choice anyway. Ultimately, it asks how we can hope to accurately discuss the ways that people make financial decisions without at least an acknowledgement of all the human factors that can affect each one.

The Revolutionaries and the Birth of a New Discipline

In the early days of behavioural finance, one of the economists leading the charge in this growing movement was Richard Thaler, who was just this week awarded the Nobel Prize for Economics! He used to keep a list of anomalies that market-based economic theories couldn't explain on the blackboard in his office in the University of Rochester. Below are a couple of examples of the sort of entries that made the list:

- The basketball fans who decide not to use free tickets to a basketball game as the weather is too bad to drive there, but who agree that had they bought the expensive tickets they would have attempted the journey in a blizzard.
- The woman who would drive to the next town to buy a radio that was being sold for £35 instead of £45 in her own town, but who wouldn't make the same journey for a TV reduced from £495 to £485.

Thaler became increasingly interested in these types of anomalies and his list kept growing, but he didn't know what to do with it until he crossed paths with two psychologists called Daniel Kahneman and Amos Tversky. Kahneman and Tversky were establishing a way of understanding common human decision-making errors as a result of the biases they held. Between them, these three academics were the founding fathers of behavioural economics and behavioural finance.

What Does It Mean for the Investor?

Our series will show how an understanding of behavioural finance can help investors, as well as advisers, as they plan for the client's financial future. In the following posts we'll be exploring a number of concepts in this area of study, including: projection and hindsight bias; overconfidence and under-confidence; self-serving bias; herding behaviour; the Gambler's fallacy; loss aversion; and, mental accounting.

At the end of each post we'll set out some questions you can ask yourself as a way to keep alert to these biases and tendencies that are present in all of us, and to help keep them in check when making investing decisions.

We'll also be including key insight and guidance from psychotherapist Professor Brett Kahr. Professor Kahr has worked in the mental health profession for over forty years. He is Senior Fellow at Tavistock Relationships at the Tavistock Institute of Medical Psychology, in London, and, also, Senior Clinical Research Fellow in Psychotherapy and Mental Health at the Centre for Child Mental Health in London. Professor Kahr is a Consultant to The Bowlby Centre and a Consultant Psychotherapist at The Balint Consultancy. Author or editor of ten books and series editor of more than fifty other books, he is also a Trustee of the Freud Museum London.

Behavioural finance, part 2: Prospect theory and loss aversion

There's a tipping point in the birth of all new disciplines when the scientist, or the economist, or the psychologist senses that they're on the brink of a big discovery. That moment in behavioural economics arrived with the definition of Prospect Theory.
The publication of Daniel Kahneman and Amos Tversky's 'Prospect Theory: An Analysis of Decision Under Risk' was the point for behavioural economists when the wave broke, the Eureka moment, their equivalent of the day the apple fell on Newton's head.

Prospect Theory

Since the 18th century, economists had assumed that we made cold, rational, consistent decisions on the basis of what would result in the optimal outcome for us as individuals (called Expected Utility Theory, or EUT). However, Kahneman and Tversky saw that economists were using EUT as both a description of how decisions should be made as well as a description of how they were being made.

As psychologists, this struck them as absurd: they knew all too well that how we should behave and how we do behave can often be very different. In fact, the struggle between the two is pretty much what it means to be human. Kahneman and Tversky set out to understand how humans actually make financial choices, fully aware that they might uncover some irrational findings.

The results of Kahneman and Tversky's studies showed that people value losses and gains in dramatically different ways, and that we tend to make financial decisions based on the size of potential gains and losses – not on how much money we end up with. This result contradicted the assumption that traditional economic theories had always been based on, and thus Prospect Theory was born. As investors, these findings can have implications for how we manage our investment portfolio.

Loss Aversion

Prior to the birth of Prospect Theory, economists thought that, as cold rationalists, we felt almost as good about a gain of £10 as we felt bad about a loss of £10. Kahneman and Tversky's studies showed that this often isn't the case, and that we dislike losing the money much more than we like gaining the exact same amount. In terms of how we behave as financial beings, the implications are that people are ready to accept (or settle for) a situation when there's a reasonable level of gain, but will be much more prone to take risks when they think they can limit their losses. This behaviour is called loss aversion.

Professor Brett Kahr provides a more nuanced view of the psychology of losses and gains:

"It's not as simple as gains are good and losses are bad. Sometimes both gains and losses can be painful. Loss can feel like the most primitive form of deprivation but with gains come a different type of pain. It's common to feel guilty about a gain – success is a good example of this – and the fear of having to deal with the fact that your achievements have made you more successful than those around you can have a debilitating effect on many people. Also, the fear of losing that promotion you've gained, the feeling that somehow you don't deserve it or feel like a fraud can affect many people."

Implications for Investors

In our role as financial lifestyle planners, we ask clients to imagine their ideal financial lifestyle scenario. We create plans that can put our clients on the road to achieving this lifestyle, but when it comes time for our clients to take action, we often find that an aversion to some perceived loss is holding them back. The idea of losing their current lifestyle can bring anxiety, even if the switch is to something better.

For example, many people dream of selling their city home and retiring to the country. However, some people can be prevented from making this leap by the fear of losing out on a bigger pay-out for the city house if prices continue to rise. It's common to come up against a situation where clients are hamstrung by their apprehension of a loss that may or may not materialise.

This situation is made more difficult by the fact that financial gains are much easier to define and quantify than are improvements to your quality of life. A really great financial planner will tell you what you need to hear as opposed to what you want to hear. Sometimes that will be to help identify and counter potential threats. At other times, just as importantly, it will be to encourage you, inspire you, and to say, 'you know what, you're in great financial shape to do this and I think you should'.

It's important for us as advisers to adapt to the personality of our clients in these cases, and to build up the necessary trust over time to guide them throughout the journey. We do this by really getting to know and understand the ideal life they seek, and by building their confidence with a plan and a portfolio to get them there. It's not just about putting the cash in an ISA and moving on, it's about listening, and matching the financial plan to the lifestyle each client wants to create. Having something to work towards reminds us all why we get out of bed every day: to achieve the goal of building our ideal life.

Professor Kahr shares this view on the importance of trust: "Irrational behaviour in the making of financial decisions has its roots in other realms of experience, well beyond those restricted to finance and investment. One's decision-making will often depend upon one's pre-existing psychological character structure; for instance, a person might be excessive or impulsive or retentive, and these particular characterological styles will inform how he or she approaches monetary matters. Financial advisers must take the time to build a relationship with people in a collaborative way so that they can better understand the vulnerabilities and idiosyncrasies of each client. This may well be crucial to long-term investment success."

Questions to Ask Yourself

How strongly do you agree or disagree with the following statements?

- I hold on to investments that I bought for more than their current value in the hope that they rebound.
- I would be frustrated if an investment increased in value after I'd sold it.
- I prefer to sell investments that have gone up since I have bought them to those which have gone down.
- I would rather cut my losses and sell a stock than wait to see if it will bounce back.

Availability and representativeness

It seems like every few weeks we hear a story about a big lottery win on the news. We might notice a work syndicate has had a windfall; or maybe the three-week rollover total has finally been won by a lucky ticketholder; or, tantalisingly, the winner of a jackpot three months ago hasn't yet claimed their prize, which puts us all on the lookout for discarded tickets.

With regular examples of these lucky winners all around us, have you ever found yourself thinking that the probability of a win can't really be all that remote?

I can't speak to whether lottery organisers have a good grasp of the fundamentals of behavioural economics, but keeping media stories about big jackpot wins in the news will certainly help to sell tickets.

Traditional economists used to assume that investors were all perfectly rational beings, who possessed all the information they needed to make a financial or investment decision – but this isn't the case. In fact, behavioural economists would argue that when we make choices in real life, we never have every single piece of relevant information available to us. Even if we did, in the context of investing and the ever-changing nature of markets, it would be an impossible task to assess all of our investment options and make a categorically correct decision.

Instead, we make do with our limited understanding of the situation, and we use short-cuts to help us make a choice. Unfortunately, these short-cuts can often include biases that divert us from making the best choices in the moment for what we want to achieve in the future. The availability bias and representativeness bias are two examples of how what we hear about a topic, and how that fits in with what we already think we know, influences how we react to it.

Availability

Behavioural economists have found that the availability of information greatly influences our decision-making. In the case of lotteries, the highly available news reports of jackpots, rollovers and missing winning tickets floating about might leave you feeling like it's about time the windfall landed in your lap. Of course, the availability of this information does nothing to change the minute odds of winning, and so people regularly overestimate their chances of scooping the big cash prize.

People are very bad at estimating the probability of all sorts of rare events, and we often believe that events happen more frequently if instances are easier to remember. Sometimes, overestimating the likelihood of a certain event is quite beneficial: for example, it's rare for pedestrians to get hit by cars, and looking both ways before you cross the road helps keep it that way! However, when it comes to investing, gloomy economic news and stories about share price plummets or stock market crashes can have a disproportionate effect on investors' attitudes.

Access to too much information can encourage a short-term focus and too much tinkering with the portfolio, which can destroy the potential for good returns. This risk can be particularly salient for experienced investors – after all, what information is more available than your own memories? When people have had an experience with a particular investment, they are more likely to use that experience (good or bad) to inform their decision-making process in future.

The ready availability of so much information in our society can be a problem for staying committed to investment plans. At First Wealth, we emphasise the importance of being patient and sticking to the long-term plan, but it's only human to be affected by news when it comes at us incessantly, and from so many different angles. The natural tendency is to withdraw or panic. As advisers, it's our responsibility to remind our clients that we are in this for the long term, that every era has its stock market ups and downs, and that the best returns tend to be seen by investors who avoid short-term, knee-jerk reactions.

Representativeness

Whenever we encounter something new – an investment, a person, a car, a business, anything – we tend to judge or categorise it on the basis of how closely it resembles a stereotype. Although we're often not consciously aware of them, we all use stereotypes when organising things into categories and making decisions. Representativeness is a mental short-cut that people use to decide if something belongs to a category on the basis of how well that thing represents the stereotype. For example, if you are introduced to a sportsman who is seven feet tall and asked to guess whether he is a high jumper or a jockey, given what you know and understand about these sports, it's unlikely you'd guess he rides a horse for a living.

Unfortunately, sometimes we can be misled by stereotypes. When it comes to investments and financial planning, investors can mistakenly classify stocks in terms of supposedly shared qualities with a stereotypical 'good' or 'bad' investment. Sometimes this approach works, but other times it can leave us holding an investment that isn't delivering the return we were expecting, or causes us to reject an investment that would have paid off.

For example, it would be easy to assume that shares in a successful, globally renowned company represent a good investment. However, this company's success and future potential are probably already reflected in their share price, so there may be limited opportunities for making significant returns in future.

We also find that many new clients have previously been told to invest in companies who make products they like to use. This strategy is risky, because a popular product can cause the company's share price to temporarily inflate beyond its 'true' value. In other words, the fact that this company seems very representative of the stereotypical 'good investment' doesn't necessarily mean it is more likely to be one.

As financial advisers, we also suffer from stereotyping of our own profession, as slick, brash City-types who are only out to make a quick buck. In the current climate of suspicion of financial institutions, it can be difficult for advisers to win trust. If a client feels like they have been let down – or worse, misled – by a bank or firm, they might be reluctant to get advice again or to fully trust another adviser, which can be frustrating for both parties.

As Professor Brett Kahr points out, finding it difficult to trust an adviser might not be solely related to a client's financial experiences:

"Thinking about this more broadly, we know that people who have experienced many betrayals or disappointments, perhaps by parents, partners, or friends, can import this sense of mistrust into their financial lives. In view of the widespread nature of betrayal during early-life experiences, which damage our sense of trust, the reliability of the financial adviser becomes deeply important as a corrective."

We have built our business to advise people not just on their portfolios, but on what their investments can mean for their lifestyles, which provides a more rewarding and fulfilling experience for ourselves as well as our clients.

Questions to Ask Yourself

How strongly do you agree or disagree with the following statements?

- I often buy and sell investments on the basis of stories I read in the news
- I wouldn't be put off a given investment if I had previously lost money on something similar
- I prefer to invest in things that I know well
- I like to invest in companies whose products I own and enjoy using

The law of small numbers, gambler's fallacy and the hot-hand effect

The Law of Small Numbers

The law of small numbers is the name economists give to a very common mistake people make when it comes to making predictions or gauging probability. The simplest example of it is when we toss a coin. Every time we toss a coin there is a 50% chance that it will land on a head, and a 50% chance it will land on a tail. However, if we get a run of, say, five straight heads, we might start to feel as if the next time we toss the coin there will be a higher probability of it being a tail. This would be wrong because the outcome of each toss of the coin has no bearing on the next one, so the odds of each toss are still 50/50.

The reason we make this mistake, according to behavioural economists, is that humans tend to put too much faith in small amounts of information. In some situations, this approach might be valid. For example, if you have 10 red balls and 10 black balls in a bag and randomly pick five consecutive red ones without replacing them, the odds of drawing a black one next will increase. But in the case of tossing a coin, each outcome is completely independent of what came before and what will come after. Every time you have an equal chance of getting a head as you do of getting a tail.

There are a number of ways in which the law of small numbers can bias our investing decisions.

The Gambler's Fallacy

The gambler's fallacy describes how gamblers might expect, for instance, a number that hasn't come up on the lottery or on a roulette wheel for a while to be 'due'. These people are effectively making the same mistake that's highlighted by the coin-toss example, but on a larger scale: their brain is telling them that they're dealing with a finite pot of numbers that aren't replaced once they're picked. But actually, all numbers are available with every spin of the roulette wheel.

As with other biases, an interesting theory of why our brains do this looks to our evolutionary past. It might have been beneficial to expect that a series of common outcomes would be broken at some point: for example, the hunter who believes their luck will turn around after a series of failures is much more likely to eat than the hunter who gives up.

The Hot-Hand Effect

While in some cases the law of small numbers causes people to underestimate the chances of a particular outcome (as with the likelihood of seeing a run of five heads in the coin toss example), in others, it causes them to overestimate. Economists call this the 'hot-hand effect'. The name comes from basketball and the mistaken belief among fans and players that the chance of a player hitting a shot is greater following a hit on the previous shot, than a miss. It's as if they believe the player is 'on a roll' or 'in the zone' and that success will breed more success.

It might seem at first as if the gambler's fallacy and the hot-hand effect contradict each other, but they both come from the same place. In short, both make the mistake of believing that past events change the probability that a given event will happen in the future. In fact, far from being contradictory, we can imagine a scenario when both the gambler's fallacy and the hot-hand effect are employed at the same time:

Bob puts his lottery numbers on for the week, being careful to avoid numbers that have recently been drawn [gambler's fallacy], but he makes sure he gets his ticket from the shop that has sold tickets to more winners than any other in his town [hot hand effect].

The Effect on Investing

So how do these phenomena translate to the everyday way that we approach investing? The gambler's fallacy and the hot hand effect can be spotted regularly by financial advisers in the behaviour of their clients.

For example, if stock markets go up for a period, as they have done recently, some investors fear that at any minute everything is going to go into reverse. They announce they are not investing anymore as the market is sure to plummet any day now. This could be seen as an example of the gambler's fallacy – if the stock market has gone up for a while, a fall must be due. If we compare the rising stock market example to how we think about house prices, we get a totally different reaction. When house prices go up, people say they are going to invest in property as it's a safe bet because prices always go up and they see no reason why this won't continue – this is the hot-hand effect.

The house price example also touches on another topic we've addressed in this series – the availability bias. Because house price crashes are relatively rare, there's less available information about them out there so we recall them less and fear them less. But that's not to say they don't still happen and that the risk shouldn't be considered properly. If we look at the stock market example again, conversely, if stock markets go down, many investors then worry they are going to sink even lower. They don't arrive at the conclusion that an upturn is due. As a result, they don't buy when they should, when the market is low; instead, they wait until it picks up and buy when prices are rising again, missing the opportunity. This reflects aversion to loss which we have also looked at.

There is a great deal of interplay between the biases of behavioural finance. Many of them have their basis in some of our earliest childhood experiences. As Professor Brett Kahr says:

"As every parent knows only too well, newborn infants specialise in what psychologists refer to as "magical thinking". In other words, we magically expect that a mummy or a daddy will automatically bring us milk and biscuits, or will cuddle us, or change our nappies, just as they did yesterday, and the day before that. Great parents will gratify this magical thinking in infants and will respond to the baby's needs in the most desirous way.

“Regrettably, financial markets do not respond to our wishes as reliably as good mummies or daddies may have done. Thus, when infantile magical thinking seduces us into believing that ‘all will be well’ with our investments, we run the risk of disappointing ourselves, often hugely so. Therefore, it’s wise to collaborate in a considered way with trusted experts to help protect us from our vulnerability to the infantile thinking which lurks so deeply within our minds.”

Questions to Ask Yourself

How strongly do you agree or disagree with the following statements?

- I am confident in my ability to time the market when I buy and sell
- I wouldn’t consider an investment if I’d seen that it had recently dropped in value
- I worry about making an investment at the wrong time

Anchoring, conservatism and herding

The way we receive and process information has a big effect on how we make decisions about investing. This week we look at some examples of these effects, and consider how we can be alert to common biases when exercising our own investment choices.

Anchoring

One of the most startling findings of the study of behavioural economics is the research into anchoring. Anchoring is the tendency to attach our thinking to a reference point, even if the information has no relevance to the decision we're making. For example, a group of students in the US were told to write down the last two digits of their social security number, and then asked to give a value to a number of randomly chosen retail products. The results clearly showed that those with higher social security numbers gave the products higher values than those with the lower-digit social security numbers. The social security number, although completely irrelevant, provided the 'anchor' that influenced the answer.

We see this employed quite regularly as a sales technique. A second-hand car salesman might start the conversation with a high price from which he expects to be haggled down. Given the power of the anchor, he'll probably end up with a final price that will be higher than had he begun with an amount closer to the car's actual value.

The property market provides another a good example. If you have your house valued by a range of estate agents, they might produce a variety of different asking prices. It is human nature to anchor on the highest price. When people come to sell and find the house doesn't fetch the top valuation price, this can stop them from moving on – even if it's still a good price, provides a decent profit, and the move is the right decision according to their life plans.

Sometimes, people can cling to anchors as a reason for not taking action and for sticking with the status quo.

Conservatism

Conservatism bias is related to anchoring and happens when we see an investor clinging on to an initial opinion about an investment without properly incorporating new information. They consider their original view to be more meaningful and important than any information they learn afterwards. Typically, they take action on the basis of the old information but are less willing to act on new information that conflicts with it.

Professor Kahr explains some of the factors that can inform our behaviour:

"Many people have a very primitive, even irrational, relationship with money. For instance, when selling one's house, the haggling might represent a deep-seated greed, but it might also serve as an indication of our fear of loss. Some owners might set an unreasonable price because, at one level, they do not actually wish to sell the house, since they have lived there with their family for a long time, and might fear a kind of psychological homelessness."

Professor Kahr further underscored: “One’s private relationship with money may have nothing to do with one’s objective net worth. Many of us feel a sense of internal impoverishment of character, often due to early experiences of emotional deprivation. Consequently, many “rich” people with assets might actually consider themselves as never having enough money, partly due to greed but, also, partly due to psychological loss, this sense of internal impoverishment.”

Herding Behaviour

Apparently, on the eve of the 1929 stock market crash, business magnate and philanthropist, John D Rockefeller had said that when the bellhop in your hotel starts talking about share tips, it's time to get out of the market. Whether this tale is true or not, it certainly helps to highlight the danger of herding when choosing your investments.

The most obvious example to cite from our era is the dotcom bubble of 1999-2000. Fund managers were investing huge sums of money in new internet-related ventures. It can be particularly tempting to follow the crowd when you don’t have a full understanding of the situation – the reassurance of seeing so many others doing the same thing can exert a powerful influence (“all those people can’t be wrong, they must know something I don’t!”).

Herd behaviour, following the crowd, conforming: whatever you call it, it’s a common human instinct and one that can impact investors and advisers in equal measure. Professor Kahr notes:

“Following the herd is a very basic and primitive instinct in human nature and relates to our fear of loneliness. It’s very difficult to go against the grain in all walks of life but particularly in investing when missing out on a financial reward can put an investor in a very lonely place.”

The Effect on Investing

Of all the biases we look at in this series, anchoring is probably the one we come across most regularly as advisers. Often clients can have an idea of the percentage return they are looking for from their investments – say, for example, 7% - and might be looking to see this level of growth consistently year on year. In the 100 years between 1917 and 2016, 7% has been the average annual return for the FTSE All-Share Index but the market will very rarely return the average in a year. In the 30 years between 1987 and 2016 the same index returned above 7% on 18 occasions (the highest being 30%) and below on 12 (the lowest being -32.8%).1Given the portfolio is structured for the long term, we should build this level of fluctuation into our expectations over the investment cycle. As advisers, we need to work closely with investors to ensure that short-term anchoring doesn’t become the nemesis of a long-term disciplined investment approach.

Time was when there only used to be a handful of funds to invest in. In some ways, herding has reduced, as there’s now a much wider mandate of investments to choose from. However, the increased influence of the media – particularly social media – and the ability of investors to more easily find a herd to follow could be said to have increased it.

The demand for buy-to-let properties shows us this. The government has recently introduced regulation to make buy-to-let a less attractive option, but it nevertheless remains popular. Many investors are keen to invest in property in the belief that it will always increase in value but, as we advise, this is not always the case. Like any investment, buy-to-let might make up a part of the portfolio but investing all your money in it because everyone else is doing it would not be something we would recommend to our clients.

This is where the role of the adviser is vital. It's our job to offer guidance based not on what the most current craze is, but on professional insight with an eye on the long-term security and prosperity of your investments.

If you would like some help in planning your ideal financial lifestyle, please feel free to get in touch.

Questions to Ask Yourself

How strongly do you agree or disagree with the following statements?

- I compare my investment performance to how other investors have been doing
- I would not feel that my investments were performing well unless they were doing better than the stock market
- I would be reluctant to sell an investment that had decreased in value since I bought it
- If a lot of people I knew had made a similar investment, I would feel comfortable not seeking independent advice about it

Overconfidence and under-confidence

Self-evaluation is how we build an understanding of our own successes and failures – whether we think our actions are responsible for them, or if they're down to factors beyond our control. It can be one of the most difficult areas for us as individuals to address, because how we evaluate ourselves is driven by deep-seated personality traits and our sense of self-confidence.

Overconfidence

As you can imagine, overconfidence is not a trait that applies only to those with an interest in investing. We're all guilty of overestimating or exaggerating our chances of success in any number of personal or professional situations. Overconfidence isn't driven by incentives, it is innate — which makes it all the more powerful in its influence on our behaviour.

Instances of overconfidence are everywhere, inside and outside the world of finance. Some examples at play can reveal a minefield of blind spots. How many times in our lives have we taken part in a competition or entered a contest with the belief that we could end up actually winning it, despite a host of other competitors and the fact there can be only one winner? Much of competitive sport is driven by every single participant sharing this same belief.

Surveys regularly show up results where well over half of the respondents rate themselves as comfortably above average, which would be statistically highly unlikely. (One of my favourites is the finding that 84% of French men estimate that they are above-average lovers1). Drivers also regularly rate themselves as above average, in numbers far higher than 50%. Entrepreneurialism in our society would be far lower without the potent hit of overconfidence that powers the launch of so many new ventures and start-ups.

When it comes to investing, commentators have claimed that, 'no problem in judgment and decision-making is more prevalent and more potentially catastrophic than overconfidence'2. In an adviser's experience, overconfidence and trying to be too clever in investing can often lead to too much tinkering with the portfolio. Clients who stick to their agreed plans are the ones most likely to reap the best long-term rewards. Looking for quick gains can often undermine or even destroy the capacity for growth over the life-cycle of an investment.

Overconfidence is common in many situations and can arise for a number of reasons, as Professor Kahr explains:

"People who present as overconfident might, in fact, be hiding significant insecurities and anxieties. They project an aura of omnipotence as a creative defence against impotency. Such a character style might stem from not having had sufficient confidence in one's sense of self, which generally derives from security of attachment in early childhood. Most people will struggle with a sense of confidence at some point, as all of us began life as fragile babies. But in adulthood, the failure to accept advice from a specialist may be a reflection of fear and vulnerability. The capacity to receive advice from an expert adviser may very well be a good barometer of mental health."

Under-Confidence

While not as prevalent and pervasive as over-confidence, under-confidence can also have a detrimental impact on our investment activity. Research has shown that individuals can underestimate their abilities and chances for success when making decisions about what investments to choose. There are particular examples of investors being too conservative about their own performance relative to that of other people. We can also just be pessimistic, tending to think there's a greater probability of something bad happening to us than the average. Under-confidence as a whole can lead to inactivity and a reluctance to take on the level of risk necessary for an investor's long-term financial lifestyle goals.

On a day-to-day basis, we find that bad past experiences can also leave investors with an under-confidence that is difficult to shake. They might have been inappropriately advised, taken on too much risk, or had their fingers burnt after investing unwisely. This can often result in in a client keeping all their funds in cash for fear it might happen again, which can be a frustrating and unrewarding position to find yourself in. The presence of a trusted and experienced financial adviser is vital to help clients navigate their way through the peaks and troughs of overconfidence and under-confidence that all investors experience.

We formulate a plan which covers all elements of our clients' financial position. It's not vital that they understand all the minutiae and financial technicalities, but it is important that clients know a plan exists and has been created uniquely for them. Having a long-term financial plan that is linked to their life goals should give investors the confidence that they can commit to achieving the financial lifestyle they're seeking.

If you would like some help in planning your ideal financial lifestyle, please feel free to get in touch.

Questions to Ask Yourself

How strongly do you agree or disagree with the following statements?

- I still have high hopes for my investments, even in the face of some failed investment decisions I have made in the past.
- I often feel that I have little influence over the things that happen to me.
- I am better informed about current financial conditions than the average person.
- I am good at making financial decisions.

Self-serving bias

Last week we looked at overconfidence and under-confidence, which are both examples of self-evaluation bias. This week, we'll be looking at another form of self-evaluation, in the shape of self-serving bias.

Every sports fan can recall a game (probably many) where they felt wronged by the result, the conduct of the players, or the decisions of the referee. Some fans seem to live in a permanent state of victimisation, always feeling hard done by in one way or another. Diego Maradona's 'Hand of God' goal against England in the 1986 World Cup in Mexico is an example that English people often cite as one of the greatest sporting injustices of all time. But it's unlikely it's viewed this way in Argentina. This disparity is an example of self-serving bias, where we selectively interpret the world to suit our own beliefs and convictions.
It's not just in sport that we display this partisanship, but in many aspects of our lives we are often our own biggest fans and our own most enthusiastic cheerleaders. We believe so deeply in our own abilities that when we see success in our life, we're not at all shy in taking the credit for it and chalking it all down to our skills, ability and hard work.

However, this self-congratulatory outlook doesn't end with just claiming all the credit for success. Here, we get selective again, because as well as claiming responsibility for success, we have a tendency to reject responsibility for failure. We prefer to put failure down to factors outside of our control, like the impact of other people or just bad dumb luck. Self-serving bias can even be seen in the way governments talk about the economy. In economic good times, it's all down to the incumbent party's shrewd economic policy; in bad times, it's down to uncontrollable global market forces or the mistakes of the previous administration.

Confirmation bias and self-attribution bias

Self-serving bias has two components, which are similar and can have a joint effect on how we make decisions about investing: confirmation bias and self-attribution bias. Put simply, they are ways of confirming one's existing beliefs, or taking credit for success where it might not be due.

Confirmation bias: Imagine you just heard some private news about a company that you own shares in, or you received a tip about a future investment opportunity. In the case of confirmation bias, when we get this new information we tend to interpret it in a way that is consistent with our prior beliefs; we see it as confirming what we already believed. Perhaps you decide to act on the tip, because you felt all along that this company was on the verge of inventing the Next Big Thing – that is confirmation bias at work. It can also work in the opposite way when, for example, we discount new information that conflicts with our previous beliefs by ignoring it or choosing not to act on it.

Self-attribution bias: We see self-attribution bias occurring when we are quick to attribute our successes to our own purposeful and intentional actions but ascribe our failures to factors out of our control. This reaction is seen as a form of self-protection or self-promotion.

Implications for investors

We see confirmation bias everywhere in our lives. One example is in the papers we read, choosing titles that align with our own political views, or even in the friends we keep, spending our time with people who share and amplify our own outlook on life.

For investors, the problem with confirmation bias is that the tendency to editorialise the information coming their way could lead them to make mistakes that have a negative effect on their returns. Investors could be ignoring potentially valuable information or confirming misplaced views, meaning they end up with a one-sided understanding of a situation. The root of confirmation bias lies in overconfidence and a belief that your own view, or the initial view you held, is the right one. You will only listen to information that supports what you already believe.

Another problem for an investor with a strong self-serving bias is that they may not be able to accept the information an adviser gives them. This, in turn, can be problematic for a relationship based on trust. Being selective with information and blaming other factors if things aren't working out is not the way to plan for your financial future. It is about being open to accepting guidance so you can take responsibility for your finances. If you don't do it, no one else will.

This phenomenon is common in everyday life also, as Professor Kahr explains:

"The self-serving bias offers us not only a temporary sense of psychological comfort – often false comfort – but, in more extreme instances, it might represent an attack on truth, sometimes approaching delusional proportions. The psychotherapist, like the financial adviser, must endeavour to find a diplomatic way to help his or her patients or clients to confront some often-unpalatable truths in a sensitive and digestible manner."

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Questions to Ask Yourself

How strongly do you agree or disagree with the following statements?

- I tend to get all my financial news from the same one or two sources.
- I can remember more examples of times I was proved right by the markets than times I was proved wrong.
- When it comes to investing, I believe I am in the best position to decide what's right for my money.

Projection bias & magical beliefs

We've considered a range of biases already in our series on behavioural finance. This week we will look at 'projection bias' and how it can impact on our investment decision-making. We'll also be seeing how 'magical beliefs' can bewitch the superstitious investor.

Projection Bias

Although we may not recognise it by name, we're all familiar with how projection bias can affect us in everyday life. It's when we make the mistake of thinking that our preferences in the future will be identical to the ones we have in the present. An example of this is when we find ourselves hungry while we're in the supermarket, which can often lead to a trolley full of food we don't need, and a bigger bill to boot. The mistake we make is thinking that in future we'll be as hungry for all this food as we are when we're in the supermarket.

Projection bias is the tendency to assume that our needs, tastes and preferences will stay the same over time. In financial planning terms, this could lead to problems in gauging future expenditure correctly, and incorrect assumptions about the money we might need to set aside for retirement. It's common to think that we won't need as much money in retirement as we do when we're working, but with more time on our hands our expenditure can increase in ways we hadn't expected, particularly on leisure and holidays.

There's also the problem of the 'ostrich mentality' when people refrain from projecting altogether, and just bury their head in the sand hoping that everything will work out somehow. At First Wealth, we conduct a 'Where Are You Today?' questionnaire with clients, along with cashflow modelling, to work out how to get them from the present day to the ideal retirement they want. This helps investors to understand how their financial future is directly shaped by the daily decisions they make in the present.

Inadequate insurance cover can be another example of projection bias in action. Many people waive critical illness cover under the assumption that they will remain generally healthy. The correct level of insurance is as important to your financial planning as the make-up of your portfolio. As advisers, we regularly ask clients big questions about life, death and health, which can be uncomfortable for clients who have never engaged with these topics before. However, our job is to make sure clients have planned for all eventualities, including the curveballs that life can throw at us, which can affect your finances but have nothing to do with investing – like incapacity, illness or death. It can be easy for an adviser just to go along with the client when they reject insurance, but it's our responsibility to make clients understand how vital it is, and that they are not immortal or immune to illness. For all new clients, we recommend income protection, critical illness and life cover to make sure they and their families are protected for these eventualities.

Professor Kahr gives his insight on why we find it difficult to address questions of our health and mortality head on:

"Each of us begins our life in a helpless, infantile state in which we have no option but to depend upon the care-giving of others. Thus, we project all responsibility outwards. In view of our vulnerability, growing up becomes a challenge as we must, step by step, learn to become less dependent upon our parents. It should not surprise us that, during times of stress, we regress to more infantile states of dependency and we wallow in a state of helplessness and denial. This applies not only to our intimate relationships but also to our business affairs, as we run the risk of denying adult realities and of projecting responsibility onto others."

Magical Beliefs

Magical beliefs don't sound like a concept you'd expect to come across in a discussion of economic theory – perhaps seeming more suited to the pages of J.R.R. Tolkien. However, they're the name behavioural economists give to certain preoccupations we have as humans that have a real effect on our decision-making, but that are difficult to fit into more scientific categories. We usually refer to them as superstitions.

After two days of sunshine and warmth at the beginning of a British summer, rushing out to buy sunblock and deck chairs, then booking the week off work would be considered to be 'tempting fate'. This belief that our actions can somehow result in a change for the worst, even though the circumstances are completely beyond our control, can also affect our financial decision making.

For some people, rising share prices can make them wary about investing their money in the stock market, lest the markets start to fall as soon as they buy. These people end up sitting on their hands and watching the market go up, trying to pick the perfect time to invest. As any good advisers will say, it's 'time in the market' rather than 'timing the market' that will bring results. Drawing up and sticking to a long-term plan is a far more reliable route to your financial goals than short-term gaming of the market. As an adviser with an eye on the markets at all times, I too can be tempted to cash in on some of my own long-term investments if they have done well, but I have to remind myself of the commitment I've made over the long-term. I try to coach myself in the same way I coach my clients.

Speaking of magical beliefs, when choosing a financial advisory practice, some investors can find themselves bewitched by the mystique and prestige of some of the more traditional firms. Long-established firms tend to be long-established for a reason, and they can point to past and present success that underpins their reputation. However, what's important for investors is that they choose the advisory practice that's right for them, not the one with the highest profile or the longest history.

Questions to Ask Yourself

How strongly do you agree or disagree with the following statements?

- I often expect investments to decrease in value shortly after I buy them.
- I won't need to think about passing on my estate until I'm closer to retirement.
- I'm confident my financial situation in retirement will be better than average.

Mental accounting

Mental accounting is everywhere. We use it every day. It's so omnipresent that we barely realise we're doing it, but once you become aware of it, there's no avoiding it. As an idea, it sprang from a question economist Richard Thaler asked himself one day in the late seventies: 'How do people think about money?' And in his own words, he's been asking it ever since:

"I have continued to think, write and talk about mental accounting for the rest of my career. It is a lens that helps me understand the world. Thinking about mental accounting can be contagious. You may soon find yourself blurting, 'Well that really is a mental accounting problem.'"

In short, mental accounting is our tendency to think about money as being marked for different purposes. As an example, someone might have a large credit card bill they need to pay off over a number of months. At the same time, they keep a piggy bank of spending money on the kitchen table to save for their summer holiday. The summer holiday spending money is not to be touched under any circumstances, even though delaying paying off their credit card will only cost more money in the long run. Rational economic theory says that it's a no-brainer to use the money in the piggy bank to pay off the debt. However, once someone has marked the piggy bank money as too important to be touched, this emotional connection can make it very difficult to use the cash for any other purpose.

There can also be advantages to mental accounting. As we have seen, there can be downsides, but sometimes I believe it can actually help a certain type of investor to think of their money as occupying different 'pots'. It encourages investors to ringfence a portion of their funds – for example, their children's school or university fees – and conditions them not to touch it as it's "not their money". The same applies to retirement savings, if it encourages people to set sufficient funds aside for the future.

Other cases of mental accounting can be spotted in how we treat money we have won or found. Studies have shown gamblers are much more liberal and less emotionally attached to money they have won in a casino than they might ordinarily be with their funds. There's a sense that losing it doesn't harm or hurt us as much because we haven't budgeted for it and it's come to us through good fortune.

Sunk Costs

We introduced this series on behavioural finance with an example of two basketball fans who decided not to use free tickets to a basketball game as the weather was too bad to make the journey, but who agree that had they bought the expensive tickets they would have attempted to drive through the blizzard. This is an example of how we're unable to ignore 'sunk costs'. Sunk costs are the name economists give to things or services we've paid for that we can't get back. Another example is over-ordering at a restaurant but keeping on eating until you're bloated and queasy because you've paid for the meal and you don't want to 'waste it'. Traditional economists would say that as we can't get sunk costs back, we should just ignore them, even if we've chosen badly. (To be fair, behavioural economists would say this also, they would just acknowledge that doing so is far from easy).

Investing in property can be a good example of this. We met with a couple who owned a holiday home. One wanted to sell it as they rarely used it, the other wanted to keep it as they spent a significant sum renovating it and wanted to get their money's worth. I explained that the amount that has been spent on the home is irrelevant if it's not being used and, also, that any renovation work will be included in the value when sold. However, the reluctant seller remained reluctant. So, I changed my tack and asked if they would be more open to selling it if it was agreed that they would earmark all the proceeds solely for holidays and enjoying themselves in future. They said yes. Sometimes, as advisers, we need to be creative in finding a way forward!

Sunk costs don't just apply to money, they can also apply to an investment of time. We've all seen a hopeful entrepreneur on Dragon's Den who has been pitching their product for so long that they can't seem to give up and accept it's not going to be a success. They stick with it as they've already invested so much time in it. As investors, it's important to remind ourselves that what's happened in the past has gone and we need to make our decisions based on where we are today.

Professor Brett Kahr has underscored:

"In psychotherapeutic work, we often observe the notions of "sunk costs" and "mental accounting", especially in relation to troubled marriages. For instance, couple psychotherapists frequently encounter partners on the brink of divorce who ask themselves, "Is this marriage still a good investment? After all, we have sunk a lot of time and money and emotion into this partnership. Should I remain?" In other words, will one's large investment in another person still reap significant dividends? In such circumstances, couples often have difficulty deciding for themselves, in view of the profound mixture of love and hatred, of tenderness and disgust, and of loyalty and infidelity which scar so many intimate marriages over time; therefore, just as many of us will require a good financial adviser to help us with our "mental accounting", so, too, might we need the services of a good psychological professional to assist us likewise."

Questions to Ask Yourself

How strongly do you agree or disagree with the following statements?

- Having multiple investment accounts is a good way to distribute money among different goals.
- I would rather spend dividends on luxury purchases than reinvest them.
- I would be less likely to sell an investment that had lost money since I bought it.

Next steps – how we apply the insights of behavioural finance

Twenty years ago, giving financial advice meant selling financial products and packages, and earning commission. The world has changed since then. There is a quiet revolution of financial excellence emerging within the UK. New advice firms and new advisers have realised the immense power of financial planning done well. Financial planning carried out correctly can help you achieve your dreams and focuses as much on the goals of the individual as it does on the bottom line of the balance sheet. Great advisers are dealing with the psychology and emotional aspects of financial planning, rather than focusing on the money itself. There is a huge opportunity here to build on this success.

The best financial planning is always objective; we have a duty to tell clients what they need to hear, not what they want to hear. As we look to the future of our profession, it's down to us to educate and reassure investors that we have their best interests at heart. An appreciation of behavioural finance will play a huge part not just in this trust-building exercise but also in the future of the financial advice we offer.

So, how can we use a knowledge of behavioural finance to create great results? What does behavioural finance tell us about building up trusting relationships and the power of planning together? How can we use this insight to drive you towards your lifestyle goals? Here are some of the opportunities I think are waiting for us.

Raising awareness

A knowledge of behavioural finance should be an addition to traditional investment theory, not a replacement. Growing numbers of advisers are beginning to see its benefits and we need to spend time with clients, help to identify the individual biases that affect them, how this will impact their decisions and flag up the warning signs to look out for. I look forward to bringing my clients along on the journey with me as we raise the profile of behavioural finance and educate people as to what it is and exactly how it can help. Making this a part of the onboarding process with new clients is a great place to start. The advisers who commit to taking it up, embed it in their working practices and educate their clients of the tangible benefits are the ones most likely to see it bring success.

Designing the right client experiences

One of the ways to make behavioural finance relevant is to promote how it can have a real and positive effect on people's lives. By designing the right experiences, informed by the insights of behavioural finance, we can help our clients make consistently great decisions.

US financial adviser, Mitch Anthony says that successful long-term relationships succeed when we concentrate on how we make our clients feel. He put together a list of six key concepts that he believes financial planners and clients should focus on: organisation; accountability; objectivity; proactivity; education; and partnership.

Creating a contract

Once a client has become familiar with the potential pitfalls of letting emotional behaviour influence their investment decisions, advisers can start to work out how to address this for the good of their financial plans. With a knowledge of behavioural biases, the clients could sit down with the adviser and draw up a contract of their relationship, highlighting the potential biases and committing to avoiding them in future. If and when clients and advisers come to a point in their relationship where the adviser feels the client is about to make a decision which isn't in their best or long-term interests, they can revisit the contract to remind themselves of the agreement they made together. This approach is as useful for keeping advisers in check and focused on the long-term goals as it is for reminding clients of their ambitions.

Adapting the style of reporting to the length of the investment cycle

While the best general advice about investing is not to tinker with the portfolio and let the markets do their work over the long term, it is still important as advisers that we monitor the progress of the investments on a regular basis. As part of our service to clients, once we have structured their portfolio and agreed on an investment plan we will meet with them on an agreed schedule to report back on how their investments have performed in the intervening period.

However, if a client has recently put in place a 20-year investment plan for their retirement, is it appropriate or necessary to meet with them every six months to assess progress and growth? This could encourage short-term alterations to the portfolio which may have a damaging effect on returns. Perhaps in the earlier years of a long-term cycle, the focus should be almost entirely forward-looking, towards the ideal future lifestyle: ensuring they're spending as they should be, that their lifestyle goals or current situation haven't changed, and that they are still on track to achieve their ambitions. This would be a healthier approach than looking back and obsessing unnecessarily and unhelpfully on short-term returns when there's still a long way yet for the investment to go.

Constructing a portfolio according to behavioural psychology

With an understanding that investors can sometimes behave in ways that might be at odds with their long-term investing success, we could explore the question of whether we should structure a client's portfolio accordingly. We know that the approach that is most likely to result in investing success is to put a long-term plan in place and to allow the portfolio to do its work over time. However, nowadays, 24-hour news and the huge availability of information has made investors more hands-on and keen to tweak and amend their portfolio in the light of every short-term change in the investing climate. Our analysis of behavioural biases will help to identify those clients who have more composure in times of market stress, and those who are likely to make bad decisions under duress. An adviser will need to make a judgment call about the type of portfolio that is best suited to each client.

For example, in reaction to the UK's upcoming exit from the European Union, a client may ask to remove some risk from the portfolio in anticipation of this unknown quantity. We would advise against knee-jerk reaction, and reassure them that events like Brexit have already been factored in and can be absorbed by the portfolio with little or no change to the plan, but the client may still insist.

However, if at the beginning of the relationship we had structured their portfolio in the knowledge that in an environment of mass availability of information the client is likely to want to react to higher risk options, could we have mitigated this? It would mean putting together a portfolio with investments of lower risk which are less likely to cause short-term panic or knee-jerk reactions. The goal is that their portfolio remains longer invested in the market. There will be ups and downs but the benefits of compounding over time will outweigh the blips, leading to a healthier return at the end of the cycle.

An exciting future

An understanding of behavioural finance can change our approach to investing and points to an exciting future for us all. It's an area which is still in its relative infancy and I'm confident that there's so much more to come.

Our aim is to help you target your ambitions and create your ideal financial lifestyle. Harnessing the insights of behavioural finance gives us the potential to supercharge the power of financial planning to help you achieve your dreams.