Behavioral Biases

As a human being, we are prone to biases which arises when we categorize new people or information. To learn quickly, the brain connects new people or ideas to past experiences to create relevancy and hence makes us respond to the new situation in similar fashion as past ones. Such biases restrain us to make a rational decision resulting in irrecoverable losses sometimes. Hence, they need to be revisited time and again to keep an eye upon them so that it would not influence our investment decision. Biases are even more evident during the bull market as the investors get greedier, because someone else is always making more money than them. Investors fear that they are going to lose a valuable opportunity to make more money if they don't act quickly, leading the brain to take mental shortcuts resulting in biases.

Currently as the NEPSE is on its bull phase, we can observe the different kinds of behavioral biases influencing the investment decision. Let us look into the few common biases that investors tend to show in context of our capital market.

Bandwagon Effect

Bandwagon effect or herd mentality is a tendency of an investor to follow the crowd because they feel safe when there is a hefty volume of investors. As stock market is often ambiguous, the investors tend to take shelter on the idea that if everyone is doing it, then it might be a good option or the best alternative to pick. Herd mentality is especially persistent when the investors have less knowledge about the stock market and the market is rising. Since, they see other people making money, they will invest on the basis of hearsay and hence it leads to the mistakes. For example, in recent times, many new investors are entering the market, among which most of them are amateur. However, as they also seek to make more money, they will invest in the stocks which others are buying, which might not always be the good stock to invest. Additionally, investors often flock into the companies announcing new issue or right or stock dividend without properly understanding the financial strength or effect on earning power due to the increased volume of the stocks. In order to deal with the bandwagon effect, an investor need to analyze the stocks on their own and invest as per their own objective and risk appetite.

Loss-Aversion Bias

Simply put, loss-aversion bias is a bias in which people tend to strongly prefer avoiding losses as opposed to achieving gains. As a result, it leads people to hold their losers even if an investment has very little or no chance of going back up. Similarly, it also leads to risk avoidance when people evaluate a potential gain. We can take a quote from Peter Lynch's book *"One up on Wall Street"* which reflects loss-aversion bias as "Selling the winners and holding you losers is like cutting the flowers and watering the weeds." For example, in context of our stock market, many investors who purchased the stocks during the bull run of 2016 held the stocks in hopes that the price will reach their previous cost price and they won't incur capital loss. A disciplined approach to investment based on thorough analysis is a good way to alleviate the impact of loss-aversion bias. It is impossible to make experiencing losses any less painful emotionally, but analyzing investments and realistically considering the probabilities of future losses and gains may help guide an investor to making a rational decision.

Availability Bias

Availability bias refers to the inclination of investor to rely on the most immediate information that they can get their hands at the particular moment. This causes the investors to create mental shortcuts and process the information based on the most relevant information which often creates a volatility in the market. For example, the quarter effect is also one of the outcome of availability bias as investor tend to rely on the news that surround the companies during the end of the quarter. The news of a company publishing outstanding financials may induce investors to flock on buying that particular stock while some other valuable stock might be ignored just because it had one bad quarter. Similarly, the investors in our market tend to irrationally invest in hydro stocks based on the power generation news without contemplating the cost overrun and the future profitability. Giving preference to the most recent investment information may result in not conducting proper analysis or failing to consider other investment options at our peril.

Hindsight Bias

As the market and its dynamics is unpredictable, investors often try out different strategies to conquer the market, only to fail. In the end, they will simply disguise their failure by stating that they had already predicted the event or its failure. Such tendency is known as hindsight bias. Hindsight bias explains the tendency of investors to view unpredictable event as predictable once it has already occurred. For example, following the current bull run in NEPSE, we often get to hear the common statements such as “I always knew that the market was going to climb higher” “I had a feeling that the bull market is near” and so on. These statements perfectly describe the hindsight bias. In order to deal with the hindsight bias, it is advisable to keep a record of our investment decision and its outcome so that we can act on a rational way.

Apart from the above mentioned biases there are some other biases too that investors exhibit which causes them to make suboptimal decision.

Anchoring Bias

Anchoring bias occurs when an investor relies too heavily on a past reference or certain piece of information while making an investment decision. Anchoring bias causes investor to put high weightage on the reference which might have no logical relevance to the investment decision at hand. For example, while buying a certain stock, an investor might look into 52-week price range, compare the prices and finds that it is trading at half of the highest price. So, the investor thinks that it is such a bargain and buys it with an expectation that the stock will reach to that level again. This will lead to flawed decision causing losses to the investor as the stock might be quite over valued at current purchase price too.

Confirmation Bias

Confirmation bias is the tendency of investors to look into the information that confirm their own existing beliefs, hypothesis or conclusion. Confirmation bias leads the investors to fetch information that reinforces their beliefs and narrows their perspectives, resulting in missing out the bigger picture or other underlying information that might rival their opinion on investment. Let’s take an example of a hypothetical scenario where an investor has laid their eyes on the stock of a certain company. Due to the effect of confirmation bias, the investor will only look for positive information about the company, to confirm his belief that the company is going to perform well and so will its prices. This might lead the investor to ignore the fact that the company has weak performance in comparison to its peers, thus leading to irrational investment decision. To minimize the risk of confirmation bias, one should seek information that challenges our investment decision and conduct a thorough analysis.

Overconfidence Bias
Overconfidence bias has aspects of both cognitive and emotional errors but is classified as later because the bias is primarily the result of emotion. Here the people demonstrate unwarranted faith in their own intuitive reasoning, judgments and cognitive abilities. Overconfidence bias is driven by two major factors ~ *Illusion of knowledge* and *self-attribution bias*. Illusion of knowledge is where people generally do a poor job of estimating probabilities and still believe they do it well because as they are smarter and more informed than they actually are. Likewise, self-attribution is where people take credit for successes and attribute failures to some external factors. As a result of overconfidence, investors tend to do one or all of the following things, underestimate risks and overestimate the expected returns, hold poorly diversified portfolio, trade excessively and experience lower return than that of the market.

Status Quo Bias
Status quo bias is where investors do nothing (i.e. maintain the "status quo") instead of making a change. Here the investors are comfortable with keeping things the same than with change and thus do not necessarily look for better opportunities. The investors tend to maintain the existing position largely because of inactivity rather than conscious choice. As a result, they unknowingly maintain portfolios with inappropriate risk characteristics and fail to explore other opportunities. For some general investor, status quo bias maybe exceptionally strong and difficult to overcome. Financial education is essential and investors should quantify the risk-reducing and return-enhancing advantages of proper and timely portfolio movement and allocation.

Self-Control Bias
Self-control bias is a bias in which people fail to act in pursuit of their long-term, overarching goals because of a lack of self-discipline. Here the investors have an inherent conflict between short-term satisfaction and achievement of some long-term goals. When it comes to money, people may know they need to save for retirement, but they often have difficulty sacrificing present consumption because of a lack of self-control. As a result of self-control bias, investors save insufficiently for the future and upon realizing it, they accept too much risk in their portfolios in an attempt to generate higher returns putting the entire capital base at risk. People have a strong desire to consume today, which can be counterproductive to attaining long-term financial goals. Investors should ensure that a proper investment plan regarding the optimal asset allocation and should have a personal budget as it is the key to attaining long-term financial goals.

Regret-Aversion Bias
Here the investors tend to avoid making decisions that will result in action out of fear that the decision will turn out poorly. Simply put, investors try to avoid the pain of regret associated with bad decisions. Regret aversion may lead investors to hold onto positions for too long, as they are reluctant to sell in fear that the position will increase in value and they will regret having sold it. It can persuade investors to stay out of stock market just when the time is right for investing. On the upside, fear of getting in at the high point can restrict new investments from taking place. As a result of risk-aversion bias, investors become too conservative in their investment choices which can lead to long-term underperformance and potential failure to achieve investment goals. Furthermore, it may encourage herding behavior as investors may feel safer in popular investments in order to limit future potential regret.

Above mentioned list is neither exhaustive nor concludes all the biases that the investor displays over the period of their investment horizon. The temptation of using mental shortcuts will always shadow every investment decision that an investor makes, however they need to understand their own biases, identify if one occurs and keep them on the bay. For this, investor can practice a financial discipline, keep a log of their investment decision and outcome, conduct thorough analysis before making any decision and enhance their financial knowledge. However, we can't deny the fact that we are always going to be vulnerable to such biases and we can only pursuit for ways to mitigate the risk of irrational decision.