MAKING BETTER DECISIONS

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Are you biased? No? You might be surprised to learn that, in fact, we are **all** biased in some way - even if (perhaps especially if) we do not think so. **Before we can improve our decision-making, we must recognise the biases which affect us.**

Our brains use **shortcuts** all the time. Without them it would be impossible to get through the day. Every day we make thousands of decisions, and we can't do that without using shortcuts.

Each shortcut uses a **bias** – you might know them as a '**rule of thumb**' or an '**educated guess**' or '**instinct**'. **These shortcuts bypass the conscious part of our brain**. Really helpful if we need to react quickly to impending danger. Not necessarily so helpful for making complex, evidence-based, decisions. Here we look at some of the main biases affecting our decision making, and how you can reduce their impact.

CAN YOU MAKE BETTER FINANCIAL DECISIONS?

Behavioural Finance is now a well-established academic field, looking at how our biases and emotions affect our economic behaviour, often to our financial detriment.

Research by investment company Morningstar in 2021 (https://www.morningstar.com/lp/impact-of-behavioral-biases) found that **higher bias levels directly correlate with worse financial outcomes**.

This remained true even when factors such as income, education and financial literacy were controlled for. Additionally, they found that **most investors showed levels of Present Bias, Loss Aversion, Overconfidence, and Base Rate Neglect** (more on these below).

So the question is not **whether** you are biased, but **which** particular bias is affecting your decision, and to what degree.

HOW SHOULD YOU GUARD AGAINST THESE BIASES ADVERSELY AFFECTING YOUR DECISION MAKING?

- Firstly, **be aware** that they exist. Educate yourself. Once we understand that biases can influence our financial decisions, it is easier to step back and take an objective view. We give an overview of the main biases to be aware of below.

- Secondly, **slow down** your thinking. Give your critical and self-reflective faculties time to influence your initial instincts.

Those who already take financial advice are ahead of the game here, as having **a solid financial plan** in place, with firm rules on when investments are bought and sold, **provides safeguards against many of the biases** below. **Using your adviser as a sounding board** can also help you understand where a bias might be getting in the way of sensible financial planning.

10 MOST COMMON COGNITIVE BIASES

1. LOSS AVERSION

Losses are painful. Loss aversion describes how most people are far more likely to prefer avoiding a loss, rather than making the same size gain.

- This can result in holding on to an investment which has lost money, even though the prospects for that investment might be worse than one which has a better investment outlook. It can also mean that a holding which has made money is perhaps sold sooner than the fundamentals suggest, for fear that the profits may be lost.

- Reducing this bias involves reframing the choice in terms of the potential gain which may be made, rather than focusing on the loss. Also helpful is putting the loss into perspective, looking at the worst that could happen and whether that is tolerable or not.

2. ANCHORING

Our mind focuses strongly on the first piece of information received about a situation (the 'anchor'). It then interprets future pieces of information in light of that starting point, even when it is no longer relevant.

For example, you may be far more likely to buy an item on sale reduced from £1,000 (the 'anchor') to £250, than if it was simply priced at £250 to start with. Additionally you may then feel like you have saved £750 and use that to justify spending on something else!

- With investing, this can lead to an over-reliance on past performance data, which we all know is not a reliable guide to future performance.

- Anchoring bias is very strong and hard to eliminate entirely, but one way to reduce its effect is to actively question the anchor – come up with reasons why it may be wrong, and to model different outcomes.

10 MOST COMMON COGNITIVE BIASES

3. HERDING OR THE BANDWAGON EFFECT

We are innately social animals and adherence to social norms affects almost everything we do.

- This can mean that we 'go along with the crowd', sometimes even when this conflicts with our own analysis of the situation. Stockmarket movements are frequently amplified by this effect, leading to larger bubbles and deeper crashes as investors copy the behaviour of others, buying high and selling low.
- Investors who manage to pay more attention to the facts of the situation rather than the media drama can often profit from the market overreaction. Having a pre-determined investment plan can also help to slow down the decision making process, and engage critical analysis rather than a susceptibility to crowd pressure.

4. CONFIRMATION BIAS

We are prone to seek out information which supports our point of view, and ignore or devalue information which challenges that view.

- Many of us will be aware of this from the well-publicised effects of social media echo-chambers. However, it can also affect our financial decision making. With all the investment noise available, it is very easy to focus only on that information which aligns with our perhaps overly optimistic or cautious views.
- Using multiple sources of information can help give a more neutral fact base, as can bouncing ideas off an objective third party such as your adviser.

10 MOST COMMON COGNITIVE BIASES

5. BASE RATE NEGLECT

We are more likely to be swayed by a single piece of specific information than overall probabilities when judging whether something is likely.

- For example, the 'base rate information' on stock markets shows a consistent growth trend over long time periods, and so it is likely that any falls are only temporary. However, when a specific piece of news causes a market fall, some are likely to predict markets will continue to fall and be moved to sell, despite the base rate information.

- Taking time to consider your options, and talking to your adviser in such a situation, will help to refocus your mind on all of the relevant facts, and your long-term plan, and help you to avoid making short-term decisions.

6. OVERCONFIDENCE

Some investors overestimate their own knowledge and capabilities when making financial decisions.

- It is human nature to blame failures on luck, but take personal credit for success. However, it is important to be aware that both luck and skill affect both losses and gains.

- It is a Catch 22 that the most overconfident people do not believe that they are overconfident at all (see: the Dunning-Kruger effect). It is important to take on board others' opinions and to question yourself honestly. Taking third party advice can help to give you a wider, more informed, perspective.

10 MOST COMMON COGNITIVE BIASES

7. PRESENT BIAS OR HYPERBOLIC DISCOUNTING

This is our tendency towards placing greater value on smaller returns now, at the expense of larger returns in the future.

- This preference for immediate over future benefits can lead to poor long-term financial decision making. For example, making you more prone to spend and accumulate debt rather than save, as you underestimate the benefits of small regular savings for your future financial wellbeing. Those with lower levels of present bias are more likely to have plans in place for their future, spend less than their income, and have emergency funds and investments in place.

- Regularly thinking about and discussing your long-term future helps to "prime" your brain for making the decisions which place importance on the long-term rather short term. In addition, actively visualising a "future you" helps your brain place more importance on the longer-term decisions which affect you.

8. ACTION BIAS

We tend to prefer to do something rather than nothing, even if there is no real evidence to show that it might help. Taking action, especially in stressful situations, gives us the illusion of control and helps us to feel (false) comfort.

- When markets fall, investors may feel compelled to 'do something', even though they invested with the full knowledge of the rises and falls they were likely to experience along their investment journey. Especially when combined with an overconfidence bias, this can lead to unsuitable trades which make you worse off in the long run.

- Take some age-old advice from chess masters – if you think you've seen a good move, sit on your hands until you've evaluated all options. You might prevent a careless blunder, or see an even better move.

10 MOST COMMON COGNITIVE BIASES

9. SUNK COST FALLACY

We've all experienced the tendency to want to continue with a course of action we have invested time or money into, even though it may no longer be in our best interests. This is partly because of our reluctance to lose these already 'sunk' costs, and is related in part to the effect of 'loss aversion' outweighing the benefits of changing course.

- In financial terms it can lead to an aversion to selling investments at a loss, even where this may objectively be the best course of action.
- Once we are aware of this effect, we can try to reframe our decisions in terms of current and future benefits, discounting any past costs, to enable more rational decision making.

10. RECENCY BIAS OR THE GAMBLER'S FALLACY

In a series of random events, we can believe that what happens next is influenced by what has been experienced very recently.

- For example, in a series of coin tosses, if heads has come up 13 times in a row, we are more likely to think tails must come up next, when of course the probability remains evenly weighted.
- With investments, this can lead us to hold onto to stocks which have fallen, or sell investments which have risen, when the fundamentals may indicate otherwise. Again, taking time to reflect and consider your long term plan will help to avoid placing undue weight on recent events, and your adviser can help to remind you of this.

THE VALUE OF FINANCIAL PLANNING ADVICE

Using an adviser will **help you to notice when your cognitive biases are kicking in**. Your adviser will make sure that you are engaging your critical, logical thinking faculties, rather than making emotional decisions, and help you formulate a long-term plan which will help avoid biases in the future.

If you are worried about a share price fall, or stressed that you will miss out on a 'hot investment', then this is your cue to **step back and take your time** before acting. **Talk it through**, and make sure the most effective part of your brain is making the decisions for you.

Best practice financial planning techniques are all designed around an **evidence based, long-term personal financial plan**, adherence to which will help you avoid emotional bear traps along the way. **Reviews and rebalances** back to your long-term target give firm rules around buying and selling, and are a core part of your plan. Targets are only changed based upon a carefully considered incorporation of new information, rather than quick and instinctive decision making.

Talking any concerns through with your financial adviser will give you an **objective, third-party view**. Good financial planning will hold up a **mirror** to your decision making, to help you reflect on whether your motivations are indeed in your long-term best interest. Regular surveys by insurance company Scottish Widows have found **that over two-thirds of advised clients said their adviser helps them avoid emotions when investing**.

One of the most valuable elements of financial planning is in helping clients notice and correct their behavioural biases. This is in addition, of course, to the technical expertise you would expect from a chartered financial planner. **Without exception, we all suffer from cognitive biases, and we could all use some help in overcoming them**.

Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

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