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Behavioral Biases in Investing

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Overview: There are countless behavioral biases that impact a person's decision making and thus their investing. This guide will provide an overview of some of the more common biases and suggest some steps to minimize their impact.

Why does this matter?

- ❖ “If the holders of a company's stock and/or the prospective buyers attracted to it are prone to make irrational or emotion-based decisions, some pretty silly stock prices are going to appear periodically. Manic-depressive personalities produce manic-depressive valuations. Such aberrations may help us in buying and selling the stocks of other companies.” - Warren Buffett
- ❖ “It's hard to be reasonable. There are a million tricks the human mind plays on its owner. That's what causes stupidity. Think of how many times you've said to yourself, “why the hell did I do that.” - Charlie Munger

Three Common Types of Bias:

Confirmation bias - The tendency people have to seek out information that confirms pre-existing beliefs while disregarding or placing less importance on evidence that may challenge their viewpoint.

- ❖ Behavioral Defense
 - Approach the research process with an open mind
 - Deliberately search for opposing viewpoints (Ex: if you think the company is a buy, try to find a fund that is recommending the company as a sell and read their report or even try to talk to the analyst)
 - Have another investor that you trust (friend, parent, professor) spend some time attacking your thesis points

Authority bias - The tendency people have to weigh opinions of authority figures heavily. For example, a reputable Wall Street Investment Bank just bought Company A, so it must be an attractive company with a lot of upside so I should buy it as well.

- ❖ Behavioral Defense
 - While it is ok to look at analyst opinions when screening for investment ideas, always take their opinions with a grain of salt and make sure to perform your own due diligence
 - Write down your investing process and implement it before making an investment decision

Anchoring - The tendency for people to rely too heavily on the first information they are given or find. Often, when researching a company, irrelevant initial information can drastically impact an individual's analysis.

- ❖ Behavioral Defense

- Take ample time between researching ideas and making the decision to invest in an attempt to diffuse the anchor

Conclusion: It's impossible to eliminate all biases, if you think you can, you are probably susceptible to the overconfidence bias. This being said, there are ways to protect and defend yourself to minimize their impact on your investing process.

Learn from biases, be honest about your own limitations and pitfalls, and take advantage when there is a high probability that the market (or a specific company/industry) is being impacted by a bias.

General Defense Against Behavioral Biases:

- ❖ Be honest about your own limitations and pitfalls
 - Different people are more/less susceptible to different biases depending on personality, characteristics, past experiences, ect
- ❖ Use a behavioral bias checklist as a mandatory part of your investing process
 - See the example of a behavioral checklist under the “Want to learn more” section
- ❖ Study business and investment failure

Want to learn more?

- ❖ Cutler Center Essentials of Value Investing Seminar with Gary Mishuris, CFA
 - In this two-semester seminar series, hedge fund manager Gary Mishuris, CFA, will use a number of readings to discuss the investing philosophies and processes of successful value investors. With Gary’s help, you’ll be able to use these insights to build your own value investing framework. Space is limited and undergraduate and graduate students must apply for this seminar. Applications typically open early in the Fall Semester. The seminar runs for two semesters.
- ❖ Books:
 - *Influence* by Robert Cialdini
 - *Pre-Suasion* by Robert Cialdini
 - *The Psychology of Money* by Morgan Housel
 - *Thinking Fast and Slow* by Daniel Kahneman

- *Priceless* by William Poundstone
- *The Undoing Project* by Michael Lewis
- ❖ Example of a Behavioral Bias Checklist
 - Google: Behavioral value investor the Skeptics Checklist, Gary Mishuris
 - While this list of questions is a good start, to get the most out of the exercise, one must customize it to fit your own strengths and weaknesses. For example, I tend to place too much emphasis on what people in authority think (authority bias) and thus I included that in my personal checklist.

Example: The Skeptic's Checklist

Source: Gary Mishuris, CFA (<https://behavioralvalueinvestor.com/blog/2018/7/29/the-skeptics-checklist>)

1. **Do I understand this business well enough to approximately estimate its key economic characteristics in 5 to 10 years?**

This was Warren Buffett's response to my question at a group dinner 15+ years ago about what things he looks for before he invests in a company. Valuation (no matter how it is done), necessitates estimating a company's future prospects. If you cannot understand the business well enough to predict its long-term economic outcome in a narrow enough range to be useful, then how can you have a meaningful opinion on whether this company is undervalued?

2. **How strong is the company's competitive advantage? Is it getting stronger or weaker?**

A strong competitive advantage makes the business more predictable long-term. It also increases the odds that the company can sustain above-average economic characteristics. Investors too frequently get excited about the financial details without first stepping back and understanding if there is anything special *and* sustainable about the company that is likely to allow it to maintain or exceed the current level of performance.

3. **What would it take for this company to be out of business in 10 years?**

This exercise focuses your mind on what can go wrong and how wrong it has to be to lead to business failure. Some companies are more fragile than others. Some companies are nearly indestructible – almost nothing can sink them. Others rely on events taking a certain path or on getting lucky with a key product or trend for their success. If it is difficult to find a reasonable answer to this question, that's a good sign.

4. **What would it take for this company to have profits below their current level in 5 years?**

Analysts rarely model companies to have declining profits short of the most obvious cases where the business is already in decline. The typical Wall Street forecast for long-term growth is approximately twice the realized rate, in no small part due to a substantial minority of outcomes having declining long-term profitability. Answering this question will get you to think about a more realistic negative scenario than the last question.

5. **How much time and capital would it take for someone (e.g. a competitor or a new entrant) to turn this into an economically unattractive business?**

The best businesses are very hard to ruin no matter how much someone tries. Investors need to guard against adverse change to a company's economics. The best defense is a combination of a strong competitive advantage with a management team committed to strengthening it over time. If this thought exercise helps you uncover that it wouldn't take much to cause the company to become an unattractive business – beware.

6. **Can the management team build meaningful wealth for themselves over several years without the shareholders achieving an attractive return?**

Alignment is an important aspect of a quality management team. It is usually driven by intrinsic and extrinsic rewards. Intrinsic motivation, doing what one loves to do, is often strongest but harder to assess. On the other hand, it should be easy to read through the proxy statement to see if the financial incentives are such that the management only does well financially when it adds value to the shareholders. What you should be looking for is multi-year incentives with a meaningful component tied to Return on Invested Capital (or similar metrics) as well as a meaningful amount of direct stock ownership. Unfortunately, most typical incentive schemes devised by compensation consultants lack these components and can result in outcomes in which shareholders can do poorly, but managers become wealthy at their expense.

7. **What would have to happen for the company to experience financial distress due to its financial obligations?**

You want to avoid being in a situation where the company you are investing in is at the mercy of the capital markets and is forced to beg for capital at whatever terms it can get. Finding yourself in such a situation is fraught with the risk of dilution to the company's intrinsic value per share, or worse yet, a total loss for the equity holder. Things to check include the financial covenants on bank debt, the [overall level of debt](#) relative to mid-cycle profitability of the business and the timing of any large financial obligations relative to the company's internal ability to meet them.

8. **Am I being "sold" on purchasing this security by someone?**

When someone is trying to sell you on an investment in a security, it is often the case that they are choosing the timing that is somehow advantageous to them. For example, there are studies that show that stocks of Initial Public Offerings (IPOs) and secondary offerings underperform the market over the subsequent 6-12 months. One of the reasons is that frequently the company gets to choose a time when its performance is good, the prevailing sentiment is optimistic, and it can command a high price for its business. On the other hand, if you are looking at a neglected or hated security you are less likely to fall prey to this effect.

9. **How likely would I have been to approximately predict the last 10 years of this business's performance 10 years ago?**

Overconfidence is one of the most fundamental behavioral biases that there is. It's tempting to look at an exciting company and imagine a bright future for it, especially if there is already some number of years of evidence of brilliant results. Going through the mental exercise of travelling back in time before the period of this exciting performance and asking the question of whether you could have anticipated what was then still to come is a good test of how predictable this business really is. True, as the company matures it might become more predictable for structural reasons. However, if your analysis is based on extrapolating the last few years of good results into the long-term future to arrive at your value estimate for the business, this exercise can save you from some situations where you might be better off passing due to the difficulty of predicting the business's future results.

10. **What is the base-rate probability of success of investing in similar situations?**

The *inside view* is how we estimate the likelihood of our success given the specifics of a given situation. The *outside view* is the prior record of success in similar situations. Our minds work in a way that is likely to make us overconfident of success based on the inside view. Therefore, it is important to understand if we are choosing from a positively or negatively biased category to better inform our assessment of our odds of success. Some things are harder to do than others and come with a low success rate. That doesn't mean that you cannot be successful in a specific instance, but it does mean that you should be more cautious and aware of the long odds.