3 Common Investing Mistakes and How To Avoid Them

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Information about how investors really make decisions is being researched all the time. However, work in the field of behavioral finance — some of which has won the Nobel Prize in economics — has identified several key ways in which our brains trick us into seeing the investment world one way, when in reality it is something quite different. These cognitive biases include:

Anchoring Bias — This reflects our tendency to latch our thinking onto a reference point that we are familiar with — even if that reference point isn't relevant to our particular situation. In an investment context, we tend to "anchor" to the long-term average return of stocks and expect stock returns in any given year to approximate the average. But, of course, stock returns in any given year may be wildly different from the long-term average. This conflicts with our mental "anchor," which causes us to panic and make bad investment decisions when returns are negative in a single year or get extremely exuberant when returns are abnormally high.

Confirmation Bias — Too often we look only for evidence that confirms our existing beliefs while ignoring or discounting evidence that shows them to be false or questionable. If you think a potential investment is going to be a huge winner, you'll probably seek out other opinions that match yours and believe that people with conflicting beliefs "just don't get it." The investment could be a dog in many ways, but you're not willing to hear it. The result, too often, is a sizeable investment loss. A good historical example of this was in the high-technology stock boom of the late 1990s. Many investors over-allocated their investment capital to high tech stocks, ignoring both their risk profiles and the key principles of diversification. The resulting decline in these technology stocks had a greater effect on investors who had concentrated much of their wealth to this industry.

Hindsight Bias — Often, we feel that whatever happened was bound to happen, that luck or chance couldn't play a part in a given situation and that ultimately, everything that occurred could have been predicted. If stock prices fall after a long bull run, it must have been because "trees don't grow to the sky" — we knew it all along. But if stock prices continue to rise, it's because "the trend is your friend." Looking back on investments' past performance, it's natural for us to think that we — or someone — should have seen it coming and taken the appropriate action.

For example, think back to the technology stock bubble. With the elapsed time, it's easy for an investor to acknowledge there was a bubble and that stock prices had to plummet. But at the time, most investors either a) didn't see a bubble, b) saw it but didn't do anything to protect themselves or c) felt that "it's different this time." Hindsight bias often leads to a sense of overconfidence, making investors think they're much smarter or adept at picking stocks than they really are. Another name for hindsight bias is "Monday morning quarterbacking," named for the tendency for football fans to see so clearly what decisions coaches should have made in the games on Sunday.

By understanding these and other cognitive biases that affect us all, you can do a better a job of recognizing your particular biases and try hard to overcome any urges to act on your short-term emotions. It's not always easy to notice your biases and shut them down, of course.

But if you can keep your emotions in check when making investment decisions, you'll find yourself in much better shape down the road.

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