Emotions such as greed and fear play an important role in driving stock markets. Behavioural finance relates to the role of emotional biases in decision-making. Use this guide to understand how overconfidence, inertia and other aspects of human nature may come into play as you work with your financial advisor to build a well-balanced portfolio.

What is “behavioural finance”?

Behavioural finance uses psychology to understand people’s investing decisions. Human nature usually serves us well in coping with day-to-day life. But it can get in the way of success in long-term activities, such as saving and investing. There is no “cure” for human nature, but greater awareness of biases can help you, and your advisor, avoid major pitfalls.

A range of biases may affect the financial decisions made by professional and novice investors alike. They include:

- Investing with overconfidence, which can lead to inappropriate or risky investments.
- Investing to avoid loss or regret, at all costs, so that we invest in a way that won’t help us reach our goals.
- Avoiding investing decisions altogether, so we either don’t save for the future or we stick with an inappropriate strategy.
- Avoiding trying to understand complex topics, which can lead us to make uninformed decisions.

Not everyone is above average

Everyone can be susceptible to overconfidence and rate himself or herself higher than any objective measure would. For example, researchers found that most people rate themselves in the top third of the population in terms of driving ability. This can’t be true because, by definition, 50% of drivers are below average. Studies have found that overconfidence affects people from all walks of life, such as chief executives, doctors, lawyers and students. All these groups tend to overrate their ability to predict the future.¹

¹ Barber and Odean (1999), The courage of misguided convictions, Financial Analysts Journal, November/December, p. 47. The study also identifies demographic characteristics such as age, gender, marital status, and income.
Overconfidence is closely related to the human tendency to view the world in positive terms. While this can help you recover from life’s disappointments more quickly, it can also become an ongoing source of poor decision-making.

Overconfidence and investing

Overconfidence can cause real problems for investors.

Mistaking luck for skill – When a decision turns out well, we claim credit. However, when something goes badly, we tend to see the outcome as bad luck or misfortune.

Too much risk – Many investors believe they can routinely pick winning investments. As a result, they sometimes put too much of their wealth into a single investment, which can be risky. Research shows that consistently picking winning investments is incredibly hard to do, even for professional investors.2

Too much trading – Overconfident investors may buy and sell too often, which can hurt their returns.

Your financial advisor can help you avoid overconfidence and give you an objective perspective on your investment decisions.

Attitudes to risk and reward

Financial advisors will normally ask you to complete a questionnaire to establish your attitude toward risk. Your tolerance for risk tends to drive the types of investments they recommend. However, the human attitude toward risk and reward can be complex and subtle. It can change over time and in different circumstances.

Behavioural finance suggests investors are more sensitive to loss than to risk and potential return. So investors sometimes hold on to losing investments, hoping they’ll recover their losses while quickly selling winners to realise a gain. In practice, the tendency to sell winning investments and hang on to losing investments has a negative impact on investing returns.

Your financial advisor can help you evaluate whether an investment is still appropriate and contain that desire to sell winners and hold on to losing investments.

The challenge of inertia

Inertia means that people fail to take action, even on things they say they want to do, such as participating in their employer’s retirement plan. Inertia can be a barrier to effective financial planning, stopping people from saving or periodically rebalancing their portfolios.

Confusion about how to proceed lies at the heart of inertia. Uncertainty can lead people to choose the path of least resistance, which is often “wait and see.” In this pattern of behaviour, the tendency to procrastinate dominates financial decisions.

Your financial advisor can help you with a disciplined, regular investment review to help you overcome inertia.

Autopilot approaches to investing

In recent years the financial industry has designed “autopilot” systems to help overcome inertia. Many individuals fail to join their company pension plan, probably due to inertia. Automatically enrolling employees, even when they have a clear chance to opt out, boosts participation. In this case, inertia plays a positive role.

Autopilot approaches, such as committing to regular monthly investments, can help promote more rational behaviour. Using a set schedule, such as an annual review, to guide decisions can help investors avoid being swayed by market conditions, including the recent performance of a “hot” investment.

Your financial advisor can help put in place automatic investment approaches to keep you on track for meeting your financial goals.

Mental shortcuts and narrow views

People tend to focus on the behaviour of individual investments. As a result, investors often overreact when one of those investments goes through a bad patch. However, taking a “wide” focus and viewing their portfolio as a whole can help investors accept short-term losses in individual securities in pursuit of their long-term financial goals. This can help avoid making potentially unhelpful short-term investment decisions.

2 The case for index-fund investing for Canadian investors (Philips, May 2013, The Vanguard Group, Inc.).
We often separate our money into “mental accounts.” Not only do we put money into separate physical accounts (such as registered retirement savings plans, registered education savings plans and checking accounts), we tend to think of the money in each of those buckets differently, according to economists who’ve studied the phenomenon known as “mental accounting.”

Once money is labeled, we tend to assign a certain level of risk tolerance to it, depending on whether the time horizon for using those funds is one month away or 30 years into the future. As helpful as that can be for budgeting and saving purposes, mental accounting can cause us to make poor choices, such as continuing to build up a low-interest savings account while carrying a high-interest balance on a credit card.

Your financial advisor can help you evaluate your overall portfolio and avoid focusing too much on individual investments.

Using investing shortcuts

Your advisor understands the importance of holding a mix of investments in proportions that reflect your circumstances. However, behavioural finance suggests investors struggle to apply the concept.

Evidence suggests that investors use simplistic rules of thumb when structuring their investments. For example, they might invest equal amounts in several investments in equal proportion, ignoring the risk-return profile of each and the relationships between them.

Investors might understand the importance of holding a broad mix of investments, but, not knowing how to go about it, choose a simple approach. This can lead to a mix of investments that may not match the investor’s risk tolerance or ultimately meet their investment goals.

People also tend to like to invest in the familiar. They associate investments they know about with low risk. So investors in Canada might prefer to invest in Canadian companies. The danger is that your portfolio may not be diverse enough to help offset falls in any one type of investment or market.

Your advisor can help you achieve a broad mix of investments and avoid concentrating risk in one particular area.

The misuse of information

Behavioural finance identifies ways we filter and misuse information when investing. We tend to apply simplified decision-making strategies to complex situations. Sometimes these strategies are helpful, but in some cases they can mislead us.

Decisions can be “anchored” by the way information is presented. For example, large round numbers can act as anchors for investing. Numbers, such as the Dow Jones Industrial Average surpassing 16,000 points, seem to attract disproportionate interest, despite being arbitrary measures.

Some evidence suggests that recently observed or experienced events strongly influence decisions. For example, people tend to feel they have a greater chance of having a car crash if they’ve seen one recently. To give a financial example, investors are more likely fear a stock market crash when one has occurred in the recent past.

Your financial advisor can help you avoid misusing or oversimplifying information by putting it in context.

Superficial decision-making

Sometimes we make decisions based on a superficial characteristic (what a situation looks like) rather than a detailed evaluation of reality. A common financial example would be assuming that the past performance of an investment is an indication of its future performance, when in fact past performance should never be relied upon as an indicator of future returns.

People also tend to look at short-term investment performance and believe it will continue, rather than take a longer term view.

What next?

This guide has described behavioural finance and what it means as you work with your advisor to create a plan that will help you reach your financial goals. With this knowledge you should be better prepared to work with your financial advisor when constructing a long-term investment plan with a better chance of meeting your investment goals.
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