



Macro Research & Strategy

## Ten Behavioral Biases That Hurt Investors

As emotional and often irrational animals we all suffer inherent biases. They're extremely difficult to overcome, but once we identify them we can train our minds to recognize environments in which we are prone to being biased. Many of the common biases we suffer from include:

1) **The better-than-average effect**—*The better-than-average effect* is the illusion that we are better at certain things than we actually are. A 1999 study by Justin Kruger and David Dunning found that the bottom 12 percent of workers ranked themselves in the top 62 percent of workers. We tend to think the same with most things. We want to believe we're better than average drivers, lovers, and a whole slew of other things that more than 50 percent of humans can't be better than average at. But we all think it. Maybe you are better than average. But don't overestimate your actual skills. Overconfidence with markets and money is like thinking you've found the holy grail in your own head.

2) **Recency bias and the gambler's fallacy**—*Recency bias* is the tendency to overemphasize the recent past. If stocks are rising, we tend to think they'll continue rising. We're inherently narrow microeconomic thinkers. A similar effect is the gambler's fallacy. We tend to think that a random event is more or less likely to occur following a series of similar events. I had a college friend who swore that he had figured out how to win at roulette.

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Investing is won primarily on the 6 inch field between our ears.

Falling for the *gambler's fallacy*, he claimed that we just needed to wait for a series of same spins to occur and then we would bet against that outcome because the odds would then favor us.

What he was missing was that each spin in roulette is a unique environment with exactly the same odds and no connection to the last one spin or the last one million spins. We didn't use his strategy, thankfully. Markets and money aren't perfectly analogous, but each business cycle and market cycle is going to have a unique flavor. The past may rhyme but doesn't necessarily repeat. John Templeton once said that the four most dangerous words in markets are *it's different this time*. I disagree; each cycle is always different because each cycle has a unique environment, catalysts, participants, and variables driving it.

3) **The disposition effect**—The *disposition effect* describes the tendency to sell shares that have increased in value and hold onto shares that have decreased in value. This is similar to loss aversion in that we hate taking losses and hope we can always break even on our bad decisions. We hate admitting we were wrong. But the disposition effect shows the corollary. We aren't just bad sellers of losing financial assets. We are bad sellers of winning financial assets in that we tend to be more comfortable taking a small gain than taking the risk of letting it ride. Add these two emotional biases together and you have a tendency to sell your winners too early and hold on to your losers too long, thereby creating a portfolio nightmare.

4) **The sunk cost-fallacy**—The *sunk-cost fallacy* hurts many facets of our financial lives. After we've paid for something, we tend to justify an irrational response to it by rationalizing that we've already paid for the item or invested so much in it. This is our failure to think in absolute terms. During our lives and financial interactions we often will confront losing causes that shouldn't be pursued further. But again we hang on to losing positions by rationalizing what we've already put into something. Classic examples of the *sunk-cost fallacy* include finishing a meal when you're full just because you paid for it or remaining in a bad relationship because you've invested so much in it already. Sometimes you need to know when to cut your losses.

5) **Past price fixation**—*Past price fixation* is similar to the sunk-cost fallacy but applies specifically to financial markets. Have you ever held a losing position and told yourself you'll sell when the price gets back to your cost basis? If so, you've fallen for past price fixation. In financial markets it's best to understand the past, but when making decisions about financial assets you have to also realize that your purchase price shouldn't be the driving force behind your future decision to buy or sell.

6) **The bandwagon effect, herding, and confirmation bias**—The *bandwagon effect*, *herding*, and *confirmation bias* are all related to the human bias of safety in numbers. If everyone else is doing something, we not only believe that our decisions are being confirmed by the actions of others, but we also feel a sense of false safety because others are doing it. In other words, if you're wrong you can always say everyone else was wrong also.



That might make your relative position better compared to the crowd's, but it won't necessarily make your absolute position better. Be careful of always feeling better while traveling with the herd. At times they're running toward the cliff and you won't see it until you've gone over the edge.

7) **Fallacy of composition**—A *fallacy of composition* occurs when we think that what's true for part of a group is necessarily true for the group as a whole. This is extremely common in macroeconomics and financial markets. For instance, the idea that you can rotate out of existing stocks to add more cash on the sidelines for later use is a fallacy of composition. For you to move out of stocks and into cash, someone else must move out of cash and into stocks. When you think of money, it's always best to think in a macroeconomic way so as to avoid this sort of narrow and misleading perspective on the world.

8) **Political bias**—*Political bias* can be extremely dangerous in markets and money. This is the tendency to intermingle your personal political beliefs with markets and monetary decisions. Of course politics and money will always be intermingled, but that doesn't mean you have to let your political biases drive your every monetary decision. The classic example of *political bias* was the 2008 financial crisis when the US government implemented the massive federal spending plan. Many people assumed this plan wouldn't work, but those who understood the Kalecki profits equation and that deficits contribute to corporate profits recognized that the government's spending program would likely add to corporate profits and drive the S&P 500 higher. While the politically biased railed against the efficacy of the spending program, the S&P 500, in its always apolitical fashion, just chugged higher and higher as profits surged to record highs.

9) **Entertainment bias**—The financial markets can be a form of entertainment for some, but for most of us we are simply trying to find a place to allocate our assets so that they protect us against purchasing power loss and the risk of permanent loss. The financial markets are not a game, an entertainment show, or something that you should fool around with. Anyone who tells you the financial markets are for entertainment purposes is probably in the business of selling you financial entertainment for their own personal gain.



10) **Negativity bias**—Fear and bad news sell. We are prone to focus on bad news because we inherently think bad news is more important than good news. Bad news sparks our survival and problem-solving instincts. Unfortunately an excessive focus on the fear machine will also cause you to miss the reality that there’s usually a lot more good going on in the world than bad.

Orcam Financial Group, LLC

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