How to tackle the various investor biases

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From individuals who want to follow hot investment tips to those who fear making the wrong decision, different investor personality types are part of human nature. Yet, acting on some of these traits can have the potential to increase risk and affect long-term financial goals.

For advisors, helping clients become aware of these behaviour patterns or biases early on and working with them to gain perspective and provide education around factors such as diversification, risk, and the benefits of a disciplined approach to investing are key to ensuring they stay on the path to success.

Maili Wong, senior wealth advisor and senior portfolio manager with The Wong Group at Wellington-Altus Private Wealth Inc. in Vancouver, says she often sees both cognitive and emotional investment biases in action – from overconfident investors to those who overvalue holdings for sentimental reasons.

In many cases, she says, these behaviours can lead to problems such as overtrading, higher taxes and fees, under diversification and taking on too much risk.

Beyond setting up the investment plan, Ms. Wong says helping individuals understand how their emotional makeup affects their decision-making is a vital part of her role. That includes educating clients on factors in and out of their control and helping them gain perspective on their biases, the way they think and their emotional drivers.

"I often see [investor biases], usually in the beginning of the relationship, and that's where we try to do a good job of helping clients have awareness of them first – because sometimes they aren't even aware they have these biases," she says.

A 2021 Morningstar Inc. study in the U.S. found that 98 per cent of individuals exhibited at least one investor bias – traits such as overconfidence, aversion to loss or prioritizing current priorities over their long-term goals. The study also found that higher levels of bias had a direct correlation with worse financial outcomes.

Different investor behaviours can also emerge later in the advisor-client relationship.

Addressing 'fear of missing out'

Herding bias is another investor personality Ms. Wong sees in practice when clients want to participate in what others are doing or exhibit the "fear of missing out" on a trend.

In one situation, Ms. Wong started working with an individual with an overly conservative approach to investing who was seeking better results. She built a balanced portfolio from which he experienced better rates of return within his risk tolerance.

However, a few years into the client's success, he began demonstrating herding bias as he sought to participate in cryptocurrency investing with his neighbour.

Ms. Wong was able to help the client understand how different this investment was relative to his overall risk tolerance and minimize the amount he invested in it to something he was willing to lose in the casino.

"When he thought about it that way, he changed the amount he was willing to put into it," she says. "A year later, his friend had lost everything."

It can be a very strong draw to do what everybody else is doing and not feel left out, she adds.

"We come across that often and try to help our clients understand that their own financial situation may be very different from their friends and that they'll only hear about the good things," she says.

Tackling overconfidence in investing

Peter Guay, portfolio manager and team lead with the Peter Guay Team at PWL Capital Inc. in Montreal, says it's also important for advisors to recognize how some personality types can yield different results from a financial planning perspective versus the investment side.

"The people who live in the future or are constantly [thinking ahead are] great for financial planning. They're proactive, they take care of stuff, they're always ahead of the game," he says.

"In the investment decision-making side, that's dangerous, because your convictions around how the future is going to play out are, perhaps, stronger than most and those convictions are highly fraught."

For example, he says, clients who fit a profile he often sees of the "family steward" – an individual with a strong desire to ensure their loved ones are taken care of – are great to work with as they're self-assured and implement recommendations on the financial planning side proactively.

However, Mr. Guay says some may also exhibit overconfidence in their investment decisions, believe they have a clearer view of the future and want to act on it by overweighting sectors or picking stocks. By contrast, his firm's investment philosophy doesn't recommend timing the market.

At the same time, he says, there can be value in understanding what these clients are trying to achieve and a willingness to make some allowances.

"You want to satisfy those decisional benefits that they're seeking, but without threatening their larger financial situation," he says. "So, there's a reasonable balance there of saying, 'Yes, set up a play account and if you have any picks you want to make, as long as it's an amount of money that doesn't threaten their future viability.'"

Working through bias involves education

Indeed, the first step to help clients identify and work through any bias is to listen carefully and try to understand their reasoning for wanting to invest a certain way, says Mark Shimkovitz, senior wealth advisor and portfolio manager with Living Richer Wealth Management at Raymond James Ltd. in Toronto.

One investor personality that tends to come up is familiarity or home country bias, which is part of the rationale for wanting to overweight Canadian stocks significantly, often out of comfort.

Working through this bias involves education and making incremental moves to start.

For example, Mr. Shimkovitz provides context on the Canadian market, data on historical rates of return, the rationale behind reducing risk related to home country bias, and helps clients take small steps toward gaining comfort with global diversification.

"When we talk about improving returns, reducing risk and the rationale behind doing it, it tends to become a little bit easier and they tend to become a little bit more comfortable with that," he says.

Ultimately, Mr. Shimkovitz says advisors don't need to be experts in psychology, but reading up on behavioural finance concepts and understanding what drives different investor types puts financial professionals in a better position to help clients achieve success.

"When we help clients take that step back and understand why they're investing … then they become more comfortable and less likely to fall victim to these biases," he says.

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