Avoid These Common Investing Psychology Traps

The Colombo Stock Exchange recorded a growth of 6.5% during 2017.Initially the growth momentum was predominantly driven by foreign investors and at present local participation is increasing steadily. There are a few psychological or behavioral traps that lead our local investors in the wrong direction in the stock market. This article was extracted from www.investodia.com with the intention of educating the local investor community.

Anchoring Trap

Firstly, what to do we mean by anchoring? Anchoring is the use of irrelevant information as a reference for evaluating or estimating some unknown value or information. In the context of investing, one consequence is that market participants with an anchoring bias tend to hold investments that have lost value because they have anchored their fair value estimate to the original price rather than to fundamentals. As a result, market participants assume greater risk by holding the investment in the hope the security will go back up to its purchase price.

Accordingly, the so-called anchoring trap, refers to an over-reliance on what one originally thinks. For instance, if you think of a certain company as successful, you may be too confident that its stocks are a good bet. This preconception may be totally incorrect in the prevailing situation or at some point in the future.

In order to avoid this trap, you need to remain flexible in your thinking, and open to new sources of information and the reality that any company can be here today and gone tomorrow. Any manager can disappear too, for that matter.

Sunk Costs

What do you know about sunk cost? A sunk cost is a cost that has already been incurred and thus cannot be recovered. A sunk cost differs from future costs that a business may face, such as decisions about inventory purchase costs or product pricing. Sunk costs (past costs) are excluded from future business decisions, because the cost will be the same regardless of the outcome of a decision.

The sunk cost trap is just as dangerous. This is about psychologically (but not in reality) protecting your previous choices or decisions, which is often disastrous for your investments. It is truly hard to take a loss and/or accept that you made the wrong choices or allowed someone else to make them for you. But if your investment is no good, or sinking fast, the sooner you get out of it and into something more promising, the better.

It's far better not to cling to the sunk cost and to get into other assets classes that are moving up fast. Emotional commitment to bad investments just makes things worse.

Confirmation Trap

Linked to the above is the confirmation trap. It can be difficult to encounter something or someone without having a preconceived opinion. This first impression can be hard to shake because people also tend to selectively filter and pay more attention to information that supports their opinions, while ignoring or rationalizing the rest. This type of selective thinking is often referred to as the confirmation bias.

In investing, the confirmation bias suggests that an investor would be more likely to look for information that supports his or her original idea about an investment rather than seek out information that contradicts it. As a result, this bias can often result in faulty decision making because one-sided information tends to skew an investor's frame of reference, leaving them with an incomplete picture of the situation.

Consider, for example, an investor that hears about a hot stock from an unverified source and is intrigued by the potential returns. That investor might choose to research the stock in order to "prove" its touted potential is real.

People often seek out others who have made, and are still making, the same mistake. Make sure you get objective advice from fresh sources, rather than phoning up the person who gave you the bad advice in the first place. If you find yourself saying something like, "our stocks have dropped by 30%, but it’s surely best just to hang onto them, isn’t it?" - you are seeking confirmation from some other unfortunate in the same situation. You can comfort each other in the short run, but it’s just self-delusion.

Blindness

Situational blindness can exacerbate the situation. Even people who are not specifically seeking confirmation often just shut out the prevailing market realties in order to do nothing and postpone the evil day when the losses just have to be confronted. If you know deep down that there is a problem with your investments, such as a major scandal at the company or market warnings, but you read everything in the newspaper apart from the financial pages, you are probably suffering from this blinder effect.

Relativity Trap

The relativity trap is also there waiting to lead you astray. Everyone has a different psychological make-up, combined with a unique set of circumstances extending to work, family, career prospects and likely inheritances. This means that although you need to be aware of what others are doing and saying, their situation and views are not necessarily relevant outside their own context. Be aware, but beware too! You must invest for yourself and only in your own context.

Superiority Trap

For some people, the superiority trap is extremely dangerous. A lot of investors think they know better than the experts or market. Just being well educated and/or clever does not mean you don't need good independent advice and, even more so, it does not mean you can outwit the pros and a complex system of markets. Many investors have lost fortunes through being convinced that they were better than the rest. Furthermore, these people are easy prey for some of the other traps mentioned above.

There are (and have always been) professors of finance at the best universities who really are brilliant technically, and this can delude them into thinking that the pickings are easy out there in the real world. Some really do cut it, but others are in for a rude awakening beyond the ivory tower. Odd as it may sound, someone with a Ph.D. in finance may in fact lead you in the wrong direction (too calculating, too confident), while someone with no more than a high school diploma may have an amazing feel for the market and make a fortune.

The Bottom Line

Human psychology is a dangerous thing, and there are some alarmingly standard mistakes that people make again and again in the stock market. It is very easy in the heat of the moment, or when subject to stress or temptation, to fall into one of these mind traps. The wrong perceptions, self-delusion, frantically trying to avoid realizing losses, desperately seeking the comfort of other victims, shutting out reality and more can all cost you dearly.

Be aware of the nature of these traps and always be honest and realistic with yourself. Furthermore, seek advice from competent and knowledgeable people of integrity who will bring you back to reality before it is too late

Source: http://www.investopedia.com/articles/investing/060513/avoid-these-common-investing-psychology-traps.asp