



The investor's blind spots: five biases your clients will recognise

Kirit Hira · Portfolio Manager

A summary of Kirit Hira's field guide to behavioural bias in equity investing.

Markets are a mechanism for aggregating human psychology into prices. That psychology is biased in ways an attentive observer can spot, first in others and then, with some humility, in oneself.

Our portfolio manager Kirit Hira has written a short field guide to seventeen of these biases. Each one pairs the research with an everyday example and a takeaway. Every bias in it is one we at Merlon have walked into at some point. The goal, as the foreword puts it, is not to be free of them. That goal is not available to anyone. The goal is to recognise their footprints.

Five of the seventeen come up again and again in conversations with clients.

1. Loss aversion

The pain of losing a dollar bites roughly twice as hard as the pleasure of finding one. Kahneman and Tversky's 1979 work on prospect theory put the ratio at between two and two-and-a-half times, and it has been replicated across cultures, asset classes and decades.

The cost shows up as reluctance to sell. "The investor who cannot tolerate small losses will, sooner or later, hold onto large ones."



Loss aversion, from the guide.

2. The disposition effect

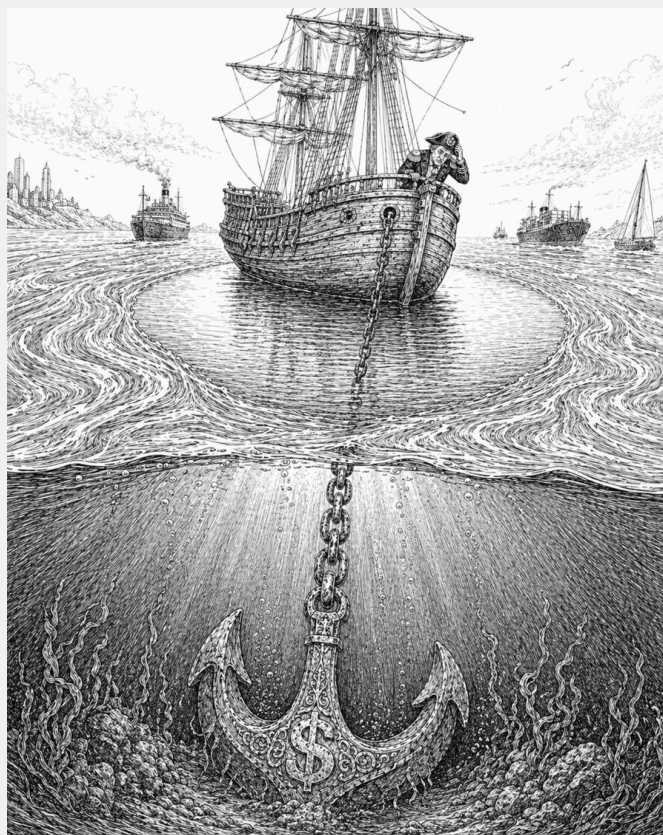
Investors sell their winners too early and hold their losers too long. In 1998 Terrance Odean studied around ten thousand brokerage accounts. He found investors sold winning stocks at a rate fifty per cent higher than losers, and the winners they sold went on to outperform the losers they kept over the following year.

"Your portfolio has no memory of what you paid for each position. Neither should your decisions. The only question that matters is: does this deserve a seat in the portfolio today?"

3. Anchoring

The first price you see, the price you paid, the fifty-two-week high: each becomes a reference point that drags later judgement towards it, whether or not it bears on the question. In Kahneman and Tversky's experiment, a wheel of fortune that had nothing to do with the question visibly moved people's estimates.

"The price you paid for a stock is not a fact about the stock. It is a fact about your autobiography."



Anchoring, from the guide.

4. Herding

When we are uncertain, we look to others for clues. In Solomon Asch's 1951 conformity experiments, three in four subjects went along with a group's obviously wrong answer at least once. At market scale, this is how bubbles form, and how they end.

"You cannot do what the crowd does and expect a different result from the crowd. Which means: most of the time, you will feel uncomfortable. Discomfort is not evidence of error. It is often evidence of opportunity."

5. Hindsight bias

After the fact, the genuinely uncertain past rewrites itself as inevitable. In Baruch Fischhoff's studies, people consistently remembered giving higher odds to what actually happened than they had at the time. The practical danger is that we learn far less from experience than we think we do.

"If everyone saw it coming, nobody did. Keep a journal of your forecasts, date them, and read them back in a year."

The question that cuts through

Several of these biases have the same antidote. Loss aversion, the disposition effect, anchoring and the sunk cost fallacy all depend on the price you paid. The guide's remedy is to ask one question of every holding: if I did not already own this, would I buy it today?

That question works for a client's portfolio. It works equally well for a fund manager on an approved product list.

The afterword ends on a hopeful note. The market does not require us to be perfectly rational, only somewhat less irrational than whoever is on the other side of the trade. That bar can be cleared by building habits, processes and relationships that catch us at the moments we are most reliably ourselves.

The full guide covers seventeen biases, with a starter reading list.

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