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HOW TO AVOID BEING A VICTIM OF INVESTMENT BIAS

Have you noticed the change in investment mood music over the past few weeks? 2011 ended with little optimism after a tough year in which most investors saw their portfolios decline amid a slew of global economic concerns.

Fast forward two months and the talk is of meaningful recovery in the world's largest economy, USA, crisis avoided in Europe – for the moment at least – and a hard landing in China looking altogether less likely. These are the key reasons why stock markets have tugged sharply upwards. In many cases, portfolio losses accumulated during the whole of 2011 have already been recovered in the early weeks of 2012. Such is the nature of markets.

The nature of investors is, however, somewhat different. Studies of behavioural tendencies show that often the greatest threats to successful investing is what goes on, not out there in the markets, but inside investors' heads.

One such threat is known as 'Conservatism bias.' According to investment experts Bodie, Kane and Marcus: "A conservatism bias means that investors are too slow (too conservative) in updating their beliefs in response to recent evidence."

The early signals of a market upswing may be present. Markets may already have moved significantly. But if your mind is still stuck in the gloom of three months ago, you will already have missed the best buying opportunity.

Closely related is a different behavioural threat referred to as 'herding.' None of us need a definition for that. We only need to think about the pre-GFC stock market boom when everyone was buying shares, or successive property cycles, to see how herd-like behaviour can lead to people making the most reckless investment decisions, believing they are safe because "everyone else is doing it."

Loss aversion is a third behavioural threat: 'The central assumption of the theory is that losses and disadvantages have greater impact on preferences than gains and advantages" (Tversky and Kahneman 1991). For investors who have followed global markets through the most volatile period in living memory, any losses they may have incurred during the past five years will make them even more reluctant to enter the market again – thereby strengthening both conservatism bias and a herding instinct away from equity investments.

This is unfortunate. Research shows that the times when markets can deliver the very best growth to investors is during the early stages of an upswing. Which is exactly when most people aren't participating. Wait for an upswing to become blindingly apparent over a period of months (confirmation bias) like everyone else (herding) and you lose out on all the initial gains.

So is now the time to be getting into the market? Is the change of mood music a sign to the alert investor that the next upswing has begun? The truth is: nobody knows. Even the most experienced and well informed market professionals are not clairvoyant. Their guess about the future may be more educated, but it is still a guess.

What we can say with confidence is that overcoming investment biases like conservatism, herding and loss aversion is difficult to achieve without objective, professional assistance. Exactly what level of exposure you should have to equities and other asset classes is as much about your own personal circumstances, temperament and financial objectives as it is about market cycles.

If you want to avoid being a victim of investment bias, rather than trying to second guess what way the market will go according to the latest headline, you're better off sitting down with a qualified financial adviser. He or she will help review any existing investments and help structure a portfolio with exposure to the right asset classes to help deliver the outcomes you seek from your long term investment journey. Bias free!

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