InvestSense

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Behavioural biases: Unravelling our irrational investment habits

In the midst of market volatility, currency fluctuations, and a climate of uncertainty surrounding South Africa's growth prospects, it becomes increasingly important to explore the common biases that can significantly impact financial decision-making. Biases, inherent to human psychology, often influence our judgments and actions in ways that may not align with rational economic principles. These biases become particularly relevant as we navigate the challenges posed by the current landscape. From Eskom's persistent power supply issues to concerns over corruption and political uncertainty, these factors have contributed to a loss of faith in the system by many investors. By understanding and addressing these biases, individuals can strive to make more informed financial choices, mitigate risks, and potentially navigate turbulent market conditions with greater resilience.

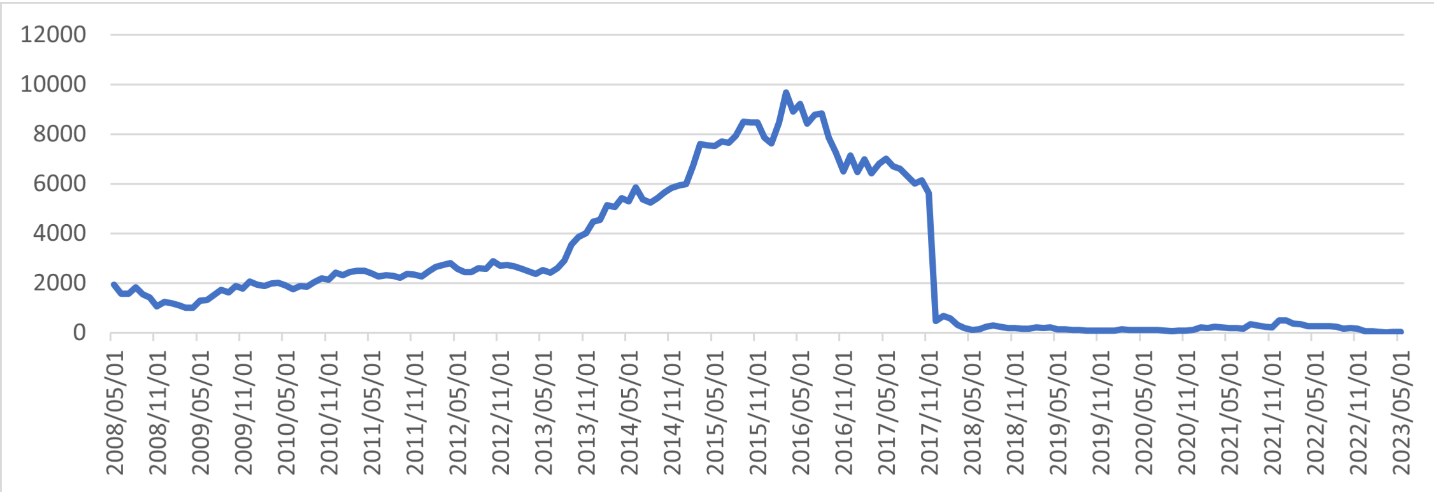
In this article, we look at five of the most common behavioural biases that influence an investor’s decision making.

1. Confirmation Bias:

Let's start with one of the most common biases in finance - confirmation bias. This bias leads us to seek information that confirms our existing beliefs and ignore evidence that challenges them. An investor might have a strong belief that a particular industry or company is poised for success, leading them to selectively consider news and reports that support this belief. Unfortunately, this bias can hinder objective decision-making and prevent investors from considering alternative perspectives.

One example of a well known share that has experienced confirmation bias in the past is Steinhoff International Holdings N.V. (Steinhoff), a multinational retail holding company based in South Africa.

Chart 1: Steinhoff Historical Share Price



Source: Sharenet.co.za

Before the revelations of accounting irregularities in late 2017, Steinhoff was considered one of South Africa's most successful and promising companies. It had a track record of rapid expansion, acquiring various retail chains globally and gaining the trust of many investors.

Confirmation bias became evident as many investors and analysts held a positive view of Steinhoff's financial performance and growth potential by focusing on all the good news. They focused on the company's consistent revenue growth, its high-profile acquisitions, and the apparent strength of its balance sheet which led to continued buying and an increase in its share price.

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However, when the accounting irregularities were exposed, it was revealed that Steinhoff had manipulated its financial statements, leading to a significant loss in market value and a collapse in investor confidence. This revelation highlighted how confirmation bias had influenced investors' perceptions of the company.

Despite analysts pointing out warning signs and red flags, such as complex and opaque financial structures, and even being laughed out of court, some investors chose to ignore or downplay these indicators that contradicted their optimistic viewpoint. They selectively interpreted positive news and disregarded or undervalued information that highlighted potential risks or inconsistencies in Steinhoff's financial reporting.

The example of Steinhoff demonstrates how confirmation bias can cloud judgment and lead investors to overlook critical information that contradicts their preconceived notions. It serves as a cautionary tale about the importance of conducting thorough due diligence and considering diverse perspectives when making investment decisions.

2. Anchoring Bias:

Anchoring bias refers to the tendency to rely heavily on the first piece of information encountered when making subsequent judgments or decisions which can influence the valuation of assets. For instance, if an investor perceives a particular stock's fair value to be at a certain level, they might anchor their expectations to that value, even in the face of new information that suggests a different valuation. A good example of anchoring bias is house prices.

A closer to ‘home’ look at behavioural anchoring bias and the Influence of House Price Anchors

When individuals are in the process of buying or selling a house, they often encounter an anchor, such as the initial asking price, the listed price, or the most recent sale price of a similar property. This anchor serves as a reference point that influences their perception of the property's value.

Assimilation Effect: In this case, individuals tend to adjust their perception of a house's value closer to the anchor. For example, if a house is listed at a relatively high price, potential buyers might consider it to be a premium property, even if it lacks certain desirable features or is overpriced compared to similar properties in the area. This assimilation effect can lead to buyers overestimating the value of a property and making offers that are closer to the anchor price.

Contrast Effect: On the other hand, the contrast effect occurs when individuals adjust their perception of a house's value away from the anchor. If a house is listed at a significantly lower price than similar properties in the area, potential buyers might perceive it as a bargain or a distressed sale. This contrast effect can lead to buyers underestimating the value of a property and potentially making lower offers than they would for similar houses with higher anchor prices.

The anchoring bias in the housing market is further exacerbated by factors such as limited market transparency, subjective valuation methods, and emotional attachments to properties. These factors can reinforce the influence of the initial anchor and make it more challenging for buyers and sellers to objectively evaluate the true value of a house.

Another well know example was during the launch of the iPad when Steve Jobs defied the experts' prediction of a $999 price tag and surprised everyone with an actual price of $499, causing people to be amazed by its fairness due to the phenomenon of placing greater emphasis on the initial information encountered.

In the investment world, a common scenario arises when investors accumulate an overweight position in shares as a result of their current or past employment, typically through a company's share incentive scheme. However, over time, there may be a growing need to diversify these shares. Unfortunately, investors often fall into the trap of anchoring their expectations of future share prices solely based on previous highs or historical performance. They maintain the assumption that the shares will eventually reach or surpass those previous levels, disregarding changing market conditions or other factors that can impact the share price. Consequently, they tend to only consider selling when the shares breach or approach this specific threshold. This situation raises a critical question about whether potential alternative opportunities have been overlooked, irrespective of whether the share price may eventually rebound to its all-time highs.

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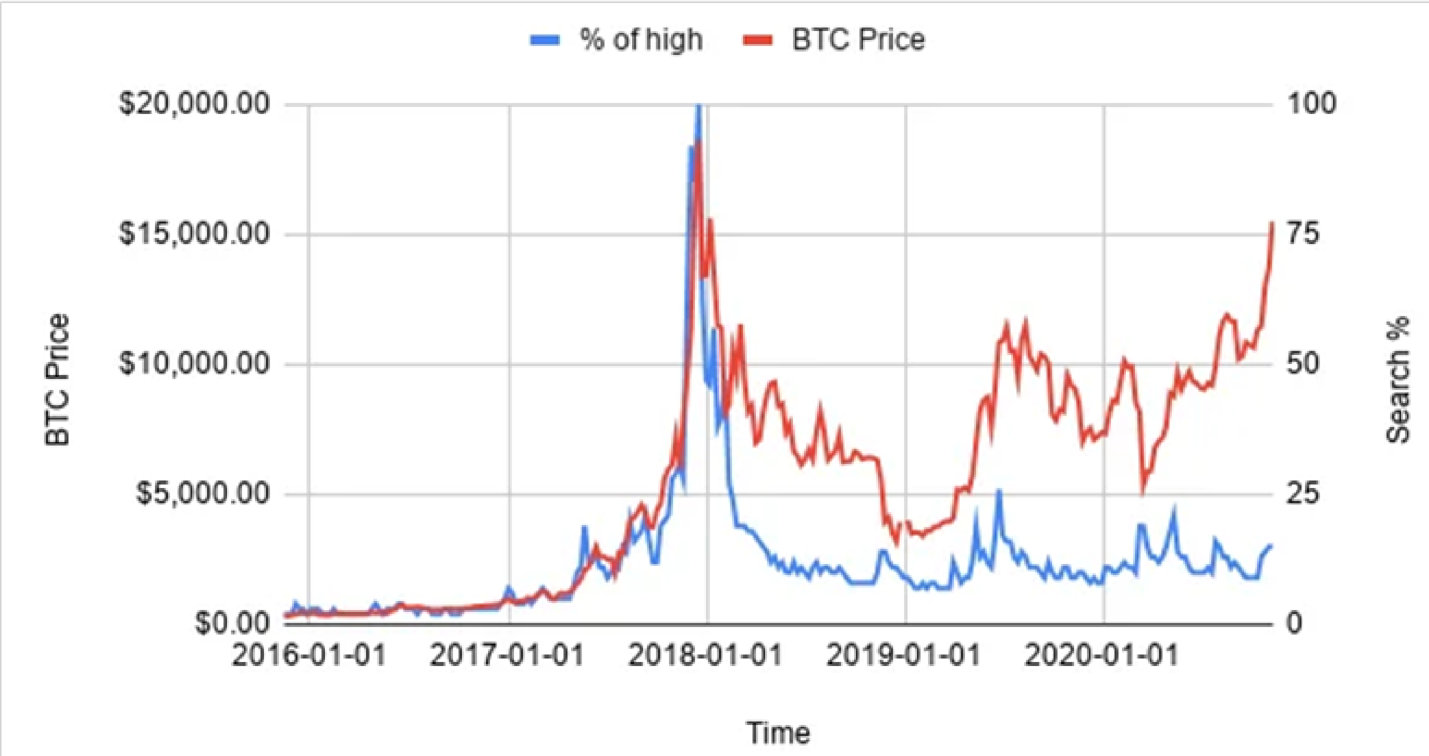
3. Herding Behaviour:

Humans are social creatures, and this is evident in financial markets through herding behaviour. This bias describes the tendency to follow the crowd and make investment decisions based on what others are doing and is often seen during periods of market euphoria or panic. When everyone seems to be investing in a particular asset or sector, individuals may feel pressured to join in, often overlooking careful analysis of the investment's fundamentals.

Research showed that there is an 80% correlation ratio between bitcoin prices and internet searches for the asset. (The table below shows a snap shot of Bitcoin price vs Googles searches for Bitcoin over a 5 year period to highlight the correlation).

Chart 2: Prices for Bitcoin vs online searches for the asset



Source: Yahoo Finance, Google Trends

On the home front amidst negative press triggering a collective exit of investors from South African-incorporated (SA Inc) stocks, herding bias emerges as investors follow the crowd. However, caution is warranted as this bias might lead to missed opportunities. Certain companies offering exceptional value and significant upside potential could be overlooked. By blindly succumbing to herding bias, investors risk missing out on undervalued opportunities that could yield favourable returns and significant upside. A discerning approach, grounded in thorough research and analysis, is essential to identify attractive investments with strong fundamentals and promising growth prospects. By capitalizing on mispricing caused by herding behaviour, investors have the potential to take advantage of this by buying assets with depressed prices. Baron Rothschild, a prominent financial figure, once famously remarked, "Buy when the blood is running in the streets." By invoking the imagery of chaos and distress, Rothschild underscores the contrarian nature of successful investors who possess the courage and insight to take action when others are fearful.

Table 1: Examples of well-known 'SA Inc' stocks trading on single-digit Price Earnings ratios as at end March 2023.

	End March 2023	Over a 5 year period (April 2018 - March 2023)		
Company name	Current P/E	Minimum P/E	Maximum P/E	Average PE
SAPPI	3.7	2.2	26.1	6.9
ANGLO AMERICAN PLATINUM	4.2	4.2	29.5	15.3
KAP	4.6	3.6	35.4	13.1
SASOL	5.0	2.8	170.6	25.8
STANDARD BANK GROUP	8.3	5.8	13.5	10.1

Source: Refinitive

4. Recency Bias:

This bias occurs when we rely on recently available information when making decisions, rather than considering the entire range of relevant data. For example, if a particular asset class has been performing well recently and receives extensive media coverage, investors may allocate an undue amount of their portfolio to that asset, neglecting the diversification principle.

Table 2: Demonstrates how last year's asset class winners are generally not in the top quartile the following year.

ASSET CLASS RETURNS IN ZAR

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD	March
Global Equities 57.2%	Global Property 27.1%	Global Property 35.4%	SA Bonds 15.4%	Emerging Markets 24.7%	Global Cash 18.6%	Global Equities [illegible]	Emerging Markets 24.7%	Global Property 40.8%	Global Cash 8.5%	Global Equities 12.5%	SA Bonds 1.3%
Global Property 27.8%	SA Listed Property 26.6%	Global Cash 34.2%	SA Listed Property 10.2%	SA Equities [illegible]	Global Bonds 14.8%	Global Property 20.5%	Global Equities [illegible]	SA Listed Property 36.9%	SA Cash 5.2%	Emerging Markets 8.5%	SA Cash 0.6%
Global Cash 23.6%	Global Equities [illegible]	Global Equities [illegible]	SA Cash 7.4%	SA Listed Property 17.2%	Global Property 9.7%	Emerging Markets 15.6%	Global Bonds 14.7%	Global Equities [illegible]	SA Bonds 4.2%	Global Bonds 7.4%	Global Equities [illegible]
SA Equities 21.4%	Global Bonds 11.1%	Global Bonds 29.7%	SA Equities [illegible]	Global Equities [illegible]	SA Bonds 7.7%	SA Equities [illegible]	SA Bonds 8.7%	SA Equities [illegible]	SA Equities 3.6%	Global Cash 5.4%	Global Bonds -0.3%
Emerging Markets 20.6%	SA Equities [illegible]	Emerging Markets 14.4%	Emerging Markets -1.5%	SA Bonds 10.2%	SA Cash 7.3%	SA Bonds [illegible]	SA Equities [illegible]	Global Cash 8.7%	SA Listed Property 0.5%	Global Property 5.2%	Emerging Markets -0.4%
Global Bonds 20.2%	Global Cash 10.6%	SA Listed Property 8.0%	Global Equities [illegible]	SA Cash 7.5%	Global Equities [illegible]	SA Cash 7.3%	Global Cash 5.8%	SA Bonds 8.4%	Global Bonds [illegible]	SA Equities [illegible]	SA Equities [illegible]
SA Listed Property 8.4%	SA Bonds 10.1%	SA Cash 6.5%	Global Property -8.4%	Global Property 4.6%	Emerging Markets [illegible]	Global Bonds 3.9%	SA Cash 5.4%	Emerging Markets 6.2%	Global Equities [illegible]	SA Bonds 3.4%	Global Cash -3.0%
SA Cash 5.2%	Emerging Markets 8.4%	SA Equities [illegible]	Global Bonds -9.9%	Global Bonds -2.8%	SA Equities [illegible]	SA Listed Property 1.9%	Global Property 0.6%	SA Cash 3.8%	Emerging Markets -14.4%	SA Cash 1.8%	SA Listed Property -3.4%
SA Bonds 0.6%	SA Cash 5.9%	SA Bonds -3.9%	Global Cash -11.2%	Global Cash -8.5%	SA Listed Property -25.3%	Global Cash -0.5%	SA Listed Property -34.5%	Global Bonds 3.5%	Global Property -19.5%	SA Listed Property -5.1%	Global Property -5.4%

Source: Refinitive

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Similarly, investors often follow top-performing funds by electing to switch in after a much-publicised run of strong performance relative to peers, frequently selling low and buying high as a result. Recency bias is often heightened at points of volatility and when investors are anxious. An example on the home front could be investors looking to externalise their investments at any cost in the aftermath of the US accusation that Russia received arms in South Africa, with the Rand crashing to a new record low of R19.83/$.

5. Home Bias:

Home bias refers to the tendency of investors to exhibit a preference for investing in their home country's assets, leading to an overallocation of investments domestically compared to offshore. In the context of South Africa, we frequently observe opposite home bias where investors show a preference for investing offshore due to recent strong offshore returns and negative sentiment towards our home country.

Between January 1995 and October 2007, a notable divergence point occurred between the developed and emerging markets. In the first phase, from January 1995 to March 2000, the developed world witnessed a growth-driven bull market known as the dot com bubble, fuelled by a surge in investments in internet and technology stocks. However, the hype surrounding start-ups reached its peak in March 2000, leading to a subsequent decline in the S&P 500, which fell by 49% from March 2000 to October 2002, and which for most of the 2000's remained negative for investors. However, at the same time, domestic investors benefited from an unexpected windfall from 2003, earning bumper returns over the next 4 or 5 years as the chart below shows. Given the dire economic recession, high interest rates and political risk in our country at the time, many investors did not benefit from this surge to the extent they could have and it would have taken a courageous investor to be fully invested in SA over this period.

Chart 3: JSE ALSI (in ZAR) vs S&P 500 (in USD) over period January 1995 to October 2007

Source: FE Analytics

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The question that lingers is: What lies ahead for SA? Will the current negative trend persist, or are we on the verge of a resurgence reminiscent of the period between 2002 and 2007?

Changing Your Thinking:

To foster more rational thinking and overcome behavioural biases, several techniques can be employed:

Decision-Making Frameworks: Implementing structured decision-making frameworks, such as setting investment criteria, defining risk tolerance, and adhering to a disciplined approach. This can help reduce the influence of emotions and biases.

Education and Awareness: Understanding the various behavioural biases that affect investment decisions is the first step towards mitigating their impact. Educating oneself about cognitive biases helps develop self-awareness and enables investors to recognize their own biases in real-time.

Seeking Diverse Perspectives: Actively seeking out diverse viewpoints and opinions, engaging in constructive debates, and considering alternative scenarios can help challenge one's own biases and promote more well-rounded investment decisions.

Regular Self-Reflection: Engaging in regular self-reflection allows investors to critically evaluate their past decisions, identify patterns of bias, and make necessary adjustments to their investment approach.

Professional Guidance: Collaborating with financial advisors or professionals who are trained to navigate behavioural biases can provide valuable insights, accountability, and a more objective perspective on investment decisions.

Conclusion:

Behavioural biases present significant challenges for investors and individuals seeking to make prudent financial decisions. The flow of money moving offshore appears to be partially influenced by a combination of these biases. However, by recognising and understanding these biases, particularly during times of heightened volatility or extreme market conditions, we can make well-informed investment choices that consider both the challenges and opportunities, both locally and globally.

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MARKET REPORT

31/05/2023

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-1.9%	4.5%	8.5%	18.5%	9.9%	9.5%	16.9%	14.2%
FTSE/JSE SA Listed Property	ZAR	-3.6%	-5.3%	-2.3%	15.8%	-4.4%	1.8%	26.9%	21.4%
SA All Bond Index (ALBI)	ZAR	-4.6%	-2.6%	0.3%	5.6%	6.2%	6.7%	8.2%	8.0%
SA Cash Index (SteFI)	ZAR	1.9%	3.1%	6.5%	4.9%	5.8%	6.2%	0.4%	0.4%
Balanced Benchmark	ZAR	0.5%	6.5%	10.4%	13.8%	9.7%	9.6%	11.6%	9.6%
SA Inflation (1 month lag)	ZAR	2.2%	2.4%	6.8%	5.5%	4.9%	5.1%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	4.1%	8.8%	2.6%	11.5%	8.3%	9.2%	18.1%	14.6%
Emerging Markets Equity (Datastream EM)	USD	0.2%	1.2%	-8.1%	3.9%	-0.3%	2.3%	18.9%	17.0%
Global Property	USD	-5.4%	-2.5%	-15.5%	2.7%	1.7%	4.0%	19.4%	16.1%
Global Bonds (Barclays Global Bond Index)	USD	1.6%	1.4%	-4.5%	-4.7%	-1.2%	0.1%	8.5%	7.4%
Global Cash	USD	1.3%	2.1%	4.2%	1.6%	1.8%	1.3%	0.5%	0.4%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-1.9%	4.5%	8.5%	18.5%	9.9%	9.5%	16.9%	14.2%
Global Equity (Datastream World)	ZAR	12.3%	26.7%	30.5%	15.9%	18.5%	16.8%	17.0%	15.2%
Emerging Markets Equity (Datastream EM)	ZAR	8.2%	17.8%	16.9%	8.0%	9.0%	9.4%	14.2%	13.5%
Global Property	ZAR	2.1%	13.5%	7.5%	6.7%	11.3%	11.3%	19.7%	17.3%
SA All Bond Index (ALBI)	ZAR	-4.6%	-2.6%	0.3%	5.6%	6.2%	6.7%	8.2%	8.0%
Global Bonds (Barclays Global Bond Index)	ZAR	9.7%	18.1%	21.5%	-0.9%	8.1%	7.1%	15.2%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	8.0%	8.6%	6.8%	4.4%	8.6%	3.5%	14.1%	14.6%
Gold (Rands)	ZAR	16.5%	26.5%	35.9%	8.6%	18.8%	10.8%		
CURRENCIES									
Rand / Dollar	ZAR	-8.0%	-16.5%	-27.2%	-4.0%	-9.4%	-7.0%	16.2%	14.8%
Rand / GBP Pound	ZAR	-10.5%	-20.0%	-25.1%	-4.1%	-7.8%	-4.9%	14.2%	14.6%
Rand / Euro	ZAR	-8.5%	-16.3%	-26.5%	-2.5%	-7.4%	-4.9%	14.0%	13.1%

Spot Rates		31-May-23	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	19.8	17.7	15.6	12.7	10.1	8.0
Rand/GBP	Rand	24.6	21.9	19.6	16.9	15.3	13.2
Rand/EUR	Rand	21.1	19.3	16.7	14.8	13.0	9.5
RATES							
Libor 6m $	US$	5.6	5.3	2.1	2.5	0.4	1.2
Repo Rate	Rand	8.25	7.75	4.75	6.50	5.00	13.50
Prime	Rand	11.75	11.25	8.25	10.00	8.50	17.00
All Bond Index Yield	Rand	10.9	10.0	11.6	9.2	7.6	9.7
COMMODITIES							
Gold ($/oz)	US$	1 971.5	1 976.5	1 845.1	1 304.1	1 392.7	363.8
Platinum	US$	1 003.0	981.0	963.0	907.0	1 459.0	642.0
Oil (Brent Crude) $	US$	73.2	79.8	123.0	77.7	101.1	26.8
INFLATION							
SA Inflation	%	6.8	6.8	6.5	4.4	5.7	9.4

data provided by to-be FE Analytics

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