SPECIAL REPORT

Porter & Co.

THE BIG SECRET ON WALL STREET

FIVE DEADLY INVESTING BIASES

AND HOW TO BEAT THEM

SCOTT GARLISS

Five Deadly Investing Biases – And How to Beat Them

Emotions and investing don't mix....

Whether you're on Wall Street or Main Street... buying stocks, bonds or any other asset... there's one concept that every investor must understand. *Emotions get in the way of investing*. When we feel attached to our investments, even professional money managers and traders make bad decisions.

In the two-plus decades I worked on Wall Street, I watched plenty of portfolio managers and analysts fall deeply, irrationally in love with their own investment picks. Then when an idea didn't work out, they got defensive and doubled down. Instead of admitting their mistake early and exiting with a small loss, they often hung on until they were in a deep hole.

Our minds are hardwired to react to stressful events with powerful emotion. The human brain is subject to "cognitive biases" – unconscious, instinctive reactions to certain situations. These can be subtle, and most people don't even recognize them. And that's how they cause trouble.

Controlling and overcoming cognitive biases requires knowing what they are – and patience and practice to deal with them. Even then, few people are ever able to surmount them.

This special report describes some of the most dangerous investment biases that plague investors... shows how those biases have played out in the lives of high-profile investors... and offers ways to address them, and reduce their impact.

The Denomination Effect

Have you ever had a $100 bill but hesitated to use it to buy anything? It felt too crisp... too big... too much money.

But at the same time, you blew through five $20 bills between Starbucks, the gas station, and CVS, without batting an eye...

This is known as the "denomination effect". Studies have shown that people hesitate to break a large bank note but have no problem spending the same amount of money in smaller

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denominations. When the value of the bank note is smaller it makes us feel like we are spending less.

In January 2020, Alphabet's (GOOGL) shares traded at $2,180. That was a relatively high price for one share, so a lot of individual investors avoided Alphabet and instead bought "cheaper" shares. They had decided Alphabet shares cost too much, based solely on the price.

(The valuation of a stock – whether it's expensive or cheap – has nothing to do with the price of a single share. The value of a stock is calculated by looking at a company's earnings, cash flow, and other factors, and then comparing them with the share price. In other words, a stock that you can buy for, say $1, might be expensive, while a $100 stock might be cheap. Price and value are only sometimes related).

Similarly, in August 2020, one Apple share cost $500. For a lot of investors, buying just 10 shares was a big investment. So, even if they could have bought a single share, a lot of investors did not touch Apple stock.

Attitudes changed when Alphabet and Apple split their shares. Google's stock split 20-for-1, meaning stockholders got twenty shares for every one share they owned, and the new shares traded at $109 (one-twentieth of the previous price). Apple's shares split 4-for-1, so after the split, the stock traded at $125 per share.

As Apple's CEO Tim Cook said, the split made the shares "more accessible to a larger number of investors." And after the split, trading volumes did spike by more than a factor of seven, compared to the expected increase of four times due to the share split. A lower share price made it easier for more investors to buy the shares – at least psychologically.

Of course, the value of each company didn't change. The lower share price only meant that investors could now buy in at a lower price. If they bought 17 or more Apple shares at $125 (total $2,180), or 20 or more Alphabet shares at $109 (total $2,180), it wouldn't have made a difference if they bought shares before or after the stock splits.

That is how the denomination effect works. Low prices can cause people to spend more – even if they end up spending the same as they would by buying something with a higher price tag.

A Low Share Price Doesn't Mean a Stock is Cheap

Jim Cramer, the animated host of CNBC's Mad Money investment show, co-founder of TheStreet.com, and former hedge fund manager, is known for his outspoken opinions.

He has taken ownership for his fair share of bad investment decisions. But he has

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said that his investment in data-storage company Memorex Telex was far and away the worst he has ever made.

Back in 1992, Memorex Telex filed for bankruptcy. Shareholders were wiped out and the bondholders received stock they didn't want to own. Cramer liked the company, but noted it had way too much debt.

After these events unfolded and the shares began trading once more, Cramer decided it was time to invest. He bought several hundred thousand shares at $2. The price quickly dropped to $1.50, and he bought more. This was all based on his belief that the company had a good business, and the cheaply priced shares couldn't go much lower.

In the end, after the stock had dropped below $1 per share, Cramer finally gave up. He said he came to the realization that "its technology was outmoded and there was nothing there." The CNBC host said he only recovered a fraction of his initial investment.

How to Handle The Denomination Effect...

Investors can overcome the "denomination effect" by thinking like they're purchasing the entire company, rather than simply taking a small stake in the shares.

If money wasn't a problem and you could buy the whole company or as much stock as you wanted, the share price wouldn't matter. You'd look at the company's balance sheet, growth potential, and the quality of their product to decide what the entire enterprise is worth.

After that, you'd decide how much of your portfolio you're willing to invest in the business. So, if you're willing to invest $100,000 in a company worth $100 million, you want to buy 0.1% of the company. The amount of stock or share price makes no difference. You're buying a piece of a business you believe in and want to be part of.

So, don't get hung up on the share price of a stock. Pay attention to its value. That will help you overcome the denomination effect.

Loss Aversion

Let's say over the next month, your investments yield a $10,000 gain. Then, a month later, you turn around and lose $10,000. Needless to say, making money is far better than losing it. But is the thrill of victory greater than the agony of defeat?

For most people, losing feels worse. However, hating losing more than loving

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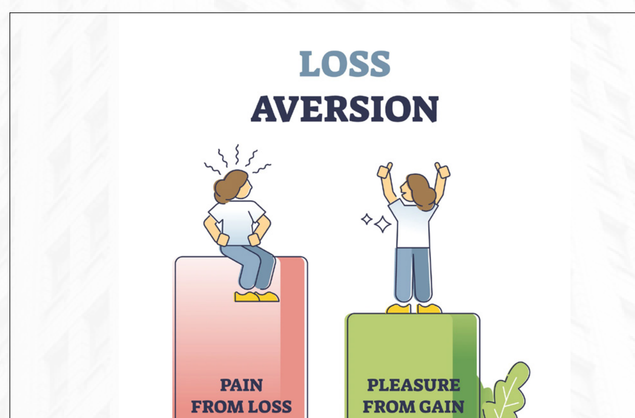
winning can result in bad investment decisions.

Research suggests our brains experience actual pain when losing money. A study by Daniel Kahneman and Amos Tversky showed that the pain experienced from losing is greater than the euphoria felt from winning an equal amount.

The pair coined the term "loss aversion". In investing, it causes people to over-exaggerate the risks of a particular asset and decide to play it safe. So, even if the chances of making $1,000 are better than losing $1,000 on an investment, most investors will avoid the opportunity altogether. That's because they exaggerate the smaller possibility of a worst-case scenario and as a result do not participate in what is, statistically, a good opportunity.

An experiment involving $50 and a coin toss demonstrated this fact. Scientists handed subjects a $50 bill and gave them two options: Keep (or "win") $30 or toss a coin to win or lose $50. Forty-three percent chose to gamble, while the rest chose to "win" (or keep) $30.



The experiment continued with participants being handed another $50 and given two options: "Lose" $20 or toss a coin to win or lose $50. The outcomes of the two different experiments were identical – "winning" $30 of the original $50, or "losing" $20. However, when the option was framed as "losing" $20 rather than "winning" $30, 61 percent of the group chose to gamble.

The inclination to avoid a loss rather than solidify a gain caused participants to make a poor choice.

Jim O'Shaughnessy Despises Losing and It Cost Him

Jim O'Shaughnessy wrote the 1997 bestseller *What Works on Wall Street*. He's also famous for using loads of historical market data to figure out market direction. His hedge fund, O'Shaughnessy Asset Management, oversees roughly $6.4 billion in assets.

According to O'Shaughnessy, his worst investment decision happened in 1987. He bought put options on the S&P 100 index. (Put options are used by investors who think markets, or stocks, will go down. They give the buyer the option to sell shares at a set, higher price.) His research indicated stocks were headed lower. So Jim bought the largest put position of his life to profit when the market went down.

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And he was right. From October 14-19, 1987, the S&P 500 dropped 28.5 percent - one of the worst declines in its history.

But, just a few days before the "Black Monday" crash on October 19, the market rallied. Consequently, the value of his put options dropped. That's when O'Shaughnessy exited his position and sold his puts… right before one of the largest one-day market crashes in history.

As he recounted, "I lost my nerve, and I emotionally sold the puts at a loss. I don't even want to tell you what I would have made if I had held on through the crash. Shoulda, woulda, coulda."

to handle Loss Aversion…

How to Handle Loss Aversion

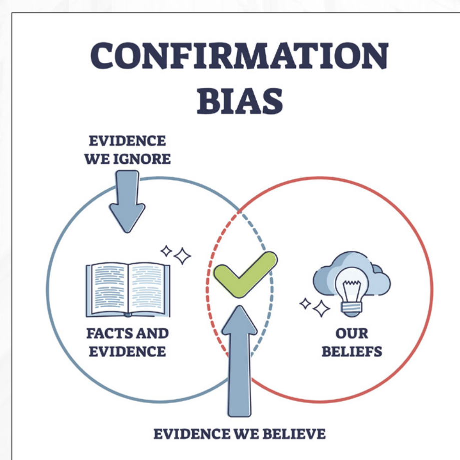
The "Overnight Test" is an easy way to avoid making bad decisions driven by loss aversion.

Let's say you invested in a stock whose value dropped. You were now faced with the decision of whether to sell at a loss or keep holding it. It's painful admitting you were wrong, of course.

But imagine you went to sleep and overnight the stock was replaced with cash. The next day, would you now use that cash to buy the same stock at the current market price or invest it somewhere else?

If you wouldn't buy the stock even at this lower price, you should probably sell.

Confirmation Bias



Everyone likes being proven correct. Most people seek out information and insight to confirm what they already believe. At the same time, they avoid information that challenges their pre-existing ideas. Many times, even opaque evidence can be used to support a conviction.

This is known as "confirmation bias". It shows up in many ways, including how we research investment opportunities.

For example, let's say an investor has decided a particular stock is headed higher. As a result of this belief, he or she is drawn to evidence confirming that view. At the same time,

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that individual ignores, or plays down the significance of, data that doesn't support the positive outlook. That's a sign of our brains looking for ways to confirm our beliefs.

Confirmation bias is more evident in politics. Those on one side of the political spectrum tend to look only at news and information that supports their pre-existing beliefs while those on the other do the same. Both groups typically ignore evidence supporting the other side.

Carl Icahn Was Too Caught Up in Blockbuster

Renowned investor, hedge fund manager, and self-made billionaire Carl Icahn says his purchase of a 16.9 percent stake in movie rental company Blockbuster was his biggest investing mistake.

In 2005, Icahn invested $320 million in the struggling video rental company. He bought the stake for about $10 per share. Blockbuster was suffering from the deadly combination of too much debt, and industry changes that threatened to make its business model obsolete. Disruptor Netflix had a much better model that was online only. (Today, video-rental stores are like trilobite fossils, a relic of a past age).

Icahn took a seat on Blockbuster's board of directors. He was hoping to bring the company back from the brink of bankruptcy. However, Icahn and other company executives did not see the changing business landscape. As late as 2007, Icahn told *Time* magazine that Blockbuster's greatest asset in the battle with Netflix was its network of stores. Blockbuster executives defended their business model, even as Wall Street analysts began thinking they were delusional.

Icahn finally sold all his Blockbuster shares in March 2010 at an average price of 26 cents per share, suffering a huge loss. The company declared bankruptcy later that year.

Hindsight makes it easy to see that video stores were doomed in the digital age. Many industry experts did see it coming, while Icahn continued promoting the benefits of the old business model.

What could have caused a savvy investor like Icahn to fail so spectacularly? Since he held onto losing shares for so long, loss aversion was likely involved. But confirmation bias played a big part as well. Otherwise, why would Icahn keep believing Blockbuster's high-cost stores could compete with Netflix's asset-lite online business?

By only sticking to facts that supported his position, Icahn failed to see the bigger-picture direction of the video-rental industry.

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How to handle Confirmation Bias…

First, understand that your brain programs you to confirm your own beliefs. Once you realize this, it's a question of actively seeking out information that goes against what you believe and presents the entire picture. So, find a view that's contrary to your own and think about it for a while.

There's a good chance you'll wind up sticking with your original belief. But your portfolio may benefit from a conscious effort to deal with this bias.

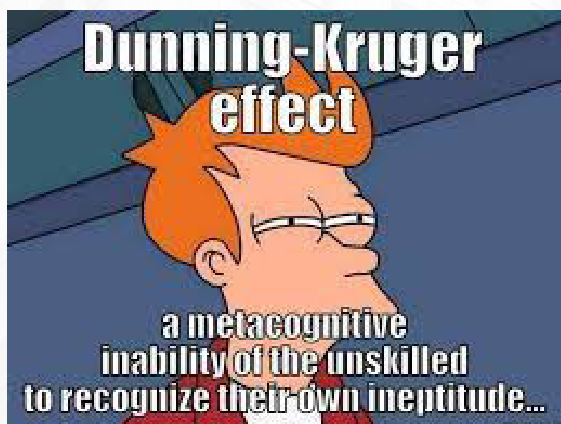
The Dunning-Kruger Effect

Sometimes, not knowing the extent of your own ignorance is even more dangerous than not knowing in the first place. That's especially true in investing.

In the aftermath of the 2008-2009 financial crisis, the Financial Industry Regulatory Authority (the U.S. broker-dealer industry regulator) and the U.S. Treasury undertook a study to find out how much people thought they understood about finance and investing. People were asked to rate their own financial knowledge, before being tested to see how much they actually knew.

Roughly 3% of the 25,000 study participants had filed for bankruptcy at least once in the past. They did not do well on the test and finished in the bottom half. But even though they obviously had poor financial skills, on average they rated their own financial knowledge as above average.

The tendency of people to think they're smarter than they are is called the Dunning-Kruger effect, named after the Cornell University psychologists who first observed it in their experiments.



David Dunning found that ignorance, not arrogance, was the main reason for this bias. You see, we sometimes have trouble rating our own abilities because we have strong preconceived ideas about ourselves. Dunning found that the least skilled or talented individuals tended to overestimate their abilities the most.

Often, investors think they know more than they actually do, in part because they have access to loads of information, data and numbers. It's easy to confuse information with real insight. The financial media doesn't help by trying to distill complex research and analysis

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into a simple conclusion: Buy and sell. That can cause us to overestimate how much we really know.

Donald Trump Understands Atlantic City Less Than He Thinks He Does

Billionaire real estate mogul (and former U.S. president) Donald Trump presents himself as a man who has never failed at anything and has never made a bad investment. While he has certainly been successful, a look back at his career also reveals some epic failures.

One of Trump's more dramatic financial calamities resulted from his casino business interests. In the early 1990s, his investments in the Atlantic City, New Jersey, gambling industry went through cycles of bankruptcy. It started in 1991 with the Trump Taj Mahal. The company filed for bankruptcy and restructured. That allowed the casino to remain open, but Trump still lost half of his investment.

Then, in 1992, he was forced to relinquish his 49 percent stake in the Trump Plaza Hotel. He stayed CEO but gave up his salary and any operational role.

Yet, despite the failures, he kept investing...

In 2004, Trump Hotel & Casino Resorts had nearly $2 billion in debt. Trump again turned to Chapter 11 bankruptcy, reducing his stake to 25 percent and giving up operational control. The company was renamed Trump Entertainment Resorts. But that didn't keep it from filing for Chapter 11 bankruptcy again in 2009, with Trump resigning from the board and reducing his stake considerably.

Since Trump made the same mistake not once, but four times, we must ask what was he thinking? Cognitive biases strike again. Reports suggest Trump's experience didn't support the big roles he took on in managing the casinos. At the same time, despite a lack of experience with complex debt transactions, he still used that type of financial engineering.

Trump's success in other areas of real-estate development likely went to his head and inflated his ego. His Atlantic City difficulties were likely the result of the Dunning-Kruger effect, or the tendency of people to think they know more than they really do.

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How to Handle the Dunning-Kruger effect...

Dealing with the Dunning-Kruger effect requires an understanding how much you don't know. That means a brutally honest assessment of your abilities. You always need to be learning and gathering new insight. Garnering feedback through the exchange of ideas can help to keep you grounded.

Understanding what you don't know can improve your choices in investing.

The Bandwagon Effect

Do you remember this question from your parents: "If everyone else decided to jump off a bridge, would you do the same?" It may have been some of the best investment advice you've ever received.

As human beings, we tend to follow the herd. We are inclined to believe that if everyone else is doing something, then it must be the right thing to do. Yet often, there is no sound, rational reason for herd mentality.

Hence the term "bandwagon effect". It's what happens when you follow the crowd without making a reasoned, objective decision on your own.

We often see the bandwagon effect in politics. Candidates use it to influence would-be voters. As an example, we can look at the 1992 U.S. presidential campaign. A study found that when voters learned Bill Clinton was in the lead, many who had intended to vote for his opponent, George H.W. Bush, changed their minds and "jumped on the Clinton bandwagon."

In fact, the phrase "jump on the bandwagon" originated in 19th century America. Dan Rice, a famous circus clown, transported politicians on his bandwagon. The music was used to attract voters to speeches. The politicians wanted to increase their appeal and be seen in a good light with voters.

Investors, like voters, feel better about their decision when they see many others doing the same thing. This is often the case when a company's share price begins to rally. As the stock goes up, everyone clamors to buy it. As others take notice, they do the same, not wanting to miss out on the gains.

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Similarly, when prices begin to drop, those same investors can rush for the exit all at the same time, fearing heavy losses. In other words, they panic and sell, too. The bandwagon effect can prevent us from thinking clearly when analyzing an investment and clouds our judgment about when to get in or out.

Rockefeller Jumps Off the Bandwagon

There's a famous story about one of the richest men who ever lived, American industrialist John D. Rockefeller. In 1928, he stopped to have his shoes shined. The young man had no idea who his customer was. So, the shoeshine boy offered several stock tips to Rockefeller. The boy had read all the financial news from the day before, and it told him markets were certain to keep rising.

Upon returning to his office, Rockefeller knew what he had to do. He immediately sold a massive chunk of his investment holdings. The Great Depression began just months later. Those actions saved Rockefeller's family from financial ruin. He knew that when the shoeshine boy is on the bandwagon, it's time to jump off.

How to Handle The Bandwagon Effect…

Some of the best investment decisions are contrarian. That's when you go against the grain. Or, as Warren Buffett famously put it, be fearful when everyone is greedy, and greedy when others are fearful.

Buying when the bandwagon crowd panics and selling when stocks can only go higher is a difficult task to always get right. But sticking to the principle can be incredibly rewarding over the long term.

A number of successful investors including Paul Tudor Jones, Marc Faber, John Neff, and Jim Rogers, consider themselves contrarians.

So, try and avoid herd mentality. If every news outlet is positive on the markets, it may be time to consider the contrarian view and be conservative.

Train Your Brain: What to Do About Your Biases

It's difficult to fully recognize our cognitive biases. Yet we all have them. Even investing legends like Icahn and Rockefeller give in to their biases and make mistakes. So, what can you do about it?

The best way to understand how to deal with cognitive biases in finance is to look at the way scientists avoid bias in their research. Scientific research and financial research involve finding conclusive evidence for a theory.

Here are three things you can do to avoid the pitfalls of cognitive biases:

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Accept

Often, it's hard to accept we're predisposed to a specific bias. After all, no one wants to think they're imperfect. But the first step in dealing with the issue is recognizing you have a bias. And once you accept it, you can change the way you work and make decisions to improve your investing decisions.

Staying current with up-to-date research will help you recognize instances when you made emotional rather than logical decisions. That will help you learn from your mistakes and avoid them in the future.

Disconnect

Treating the investment process like a business decision often leads to successful outcomes. Reacting and making panicked decisions typically leads to bad results. Employing well thought-out decisions and strategies is the path to success.

If decisions feel rushed, they probably are. Sleep on it. A lifetime of gains in the right investment will greatly outweigh any losses for taking the extra time to make certain you're making the right choice.

Stick to a List

Lastly, be disciplined. Make a list of the characteristics you look for in an ideal investment. Take notes when that strategy succeeds and fails so that you're always refining the process. That way, you'll minimize bias-based investment decisions.

If you stick to the process, it's likely you'll find a focused and methodical approach will improve your process. That way, you'll avoid getting emotional and making rash investment decisions.

To your investing success!

Scott Garliss

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