Morgan Stanley

Behavioral Finance

Understanding Its Impact on You

Discover How Psychological Influences and Biases May Affect Your Financial Behavior

Even when humans have all the facts, we can make mistakes. That's because it is difficult to remove emotions, assumptions and personal perspectives when making decisions. Morgan Stanley Virtual Advisor is here to help you overcome any potential challenges you may face while investing or financial planning.

KEY TAKEAWAYS

1
Behavioral finance is the field of psychology that studies how and why human biases influence financial markets.

2
These biases can impact our judgment about how we spend our money and decide to invest it.

3
Some common pitfalls include overconfidence bias,[1] loss aversion[2] and herd behavior.[3]

4
Understanding biases can help you overcome them and make better financial decisions.

Understanding Behavioral Finance

While we like to believe the stock market is efficient — meaning everything is fairly and accurately priced at all times — the reality is that the market is shaped by the human behaviors of buying and selling, which can be impacted by global events, headline news and personal preferences. And, if human behavior is inherently unpredictable, market inefficiencies are inevitable. This is the foundation of behavioral finance, the field of psychology that studies how and why human biases influence financial markets.

There are countless well-documented examples of behavioral finance in motion. When markets are rising, human greed can lead us to keep buying stock, even when analysts suggest otherwise.[1] When markets are falling, fear can lead us to sell, even when history has shown, time and time again, that the best thing to do in these situations is to stay invested.[1] Humans are naturally inclined to act, especially in stressful situations — and studies suggest that the bigger the decision, the greater the tendency to ignore rational factors.[4]

Results of Emotional Investing

Poor investing behavior can lead to insufficient diversification among different types of assets, chasing market performance, and moving into and out of the markets (often at the wrong time). Not surprisingly, the typical result of these behaviors is poor long-term performance, which could lead to not reaching your financial goals.

The consequences may be even more dramatic than you think. For example, the average annual return for a balanced portfolio (an initial investment of $100,000 in 65% equity and 35% fixed income) over the past 30 years was 8.8%.[5] However, the average U.S. investor received a 4.8% return, which could be a result of common investing behaviors, such as trying to time the market, holding too much in cash, chasing performance, and focusing on the short term.[5] And with the power of compounding, the difference wasn't simply 4 percentage points a year; it could have been as much as $840,000 over that 30-year time frame.[5]

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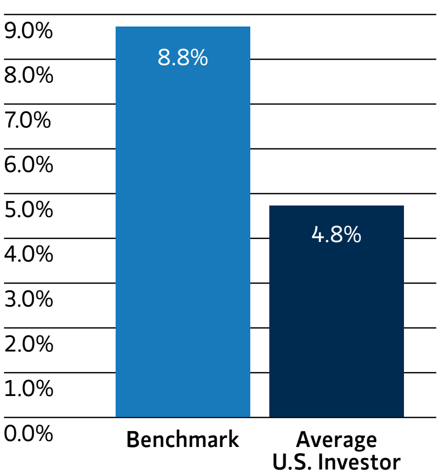
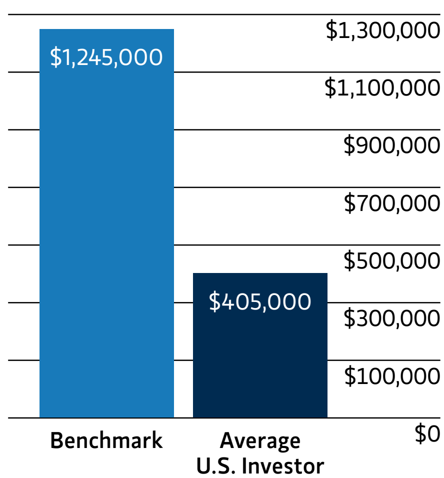
How Investing Behavior Can Lead to Poor Performance

AVERAGE RETURN PER YEAR



TOTAL PORTFOLIO VALUE AFTER 30 YEARS



Source: "2022 Quantitative Analysis of Investor Behavior," DALBAR, Inc. Annualized return for the past 30 years ending 12/31/2021. Assumes initial investment of $65,000 in equity and $35,000 in fixed income, rebalanced annually. The equity benchmark is represented by the S&P 500. The fixed income benchmark is represented by the Barclays Aggregate Bond Index. Returns do not subtract commissions or fees. This study was conducted by an independent third party, DALBAR, Inc., a research firm specializing in financial services. Past performance is not a guarantee of future results. Rounded to the nearest $5,000. Indexes are unmanaged and not meant to reflect actual investments. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

7 Common Investor Biases

Humans have innate biases that influence the way we view the world and make decisions, including decisions about money. Most biases fall into one of two categories:

Cognitive bias results from your brain's attempt to simplify information and speed up decision-making by creating shortcuts. It can cause errors in judgment when the reality your brain constructs is at odds with objective information.[6]

Emotional bias is a tendency to believe information or make decisions based on the way they make you feel, rather than their objective impacts.[7]

Here are some common cognitive and emotional blind spots that may affect your financial behavior:

- Confirmation Bias
- Loss Aversion
- Overconfidence Bias
- Recency Bias
- Anchoring Bias
- Herd Mentality Bias
- Ambiguity Aversion

BIAS NO. 1: Confirmation Bias

WHAT IT IS
A tendency to seek out information that confirms or supports what we already think and reject information that doesn't.[8]

WHAT IT CAN LOOK LIKE
While researching a particular company's stock you think you'd like to buy, you come across 10 positive headlines and 10 negative ones — and click only on the ones that support your decision.[8]

WHY IT COULD BE A PROBLEM
Limiting yourself to information that confirms what you already think may cause you to miss important warning signs.[8]

HOW YOU CAN HELP PREVENT IT
It's not always easy to read or hear things that disagree with your views; but challenge yourself to include those differing perspectives in your research. You may still make the same decision, however you'll be more informed and aware of potential issues.

BIAS NO. 2: Loss Aversion

WHAT IT IS

People don't like to lose, and loss aversion is the tendency of people to prefer avoiding losses, as opposed to acquiring equivalent gains.[9]

WHAT IT CAN LOOK LIKE

Research suggests that someone who loses $100 will feel twice the pain versus the satisfaction of gaining $100. In other words, a person would have to gain $200 for their feelings to equalize.[9]

WHY IT COULD BE A PROBLEM

If you only invest in low-risk, low-return investments, your money may not grow enough to reach long-term goals like retirement. Selling out of fear during market downturns locks in losses and may make it harder to catch up.[9]

HOW YOU CAN HELP PREVENT IT

Remember that when the market is down, you've only "lost" if you sell in that moment. Speak to a professional to become more informed and potentially hold on to your portfolio to ride out the volatility or discuss additional options before making a decision—there may be other options that could potentially lead to higher gains.

BIAS NO. 3: Overconfidence Bias

WHAT IT IS

Overconfidence bias is defined as a tendency to have a misleading assessment of ourselves, a belief wrapped in ego that we're better than we actually are.[10]

WHAT IT CAN LOOK LIKE

People are overconfident about many things: their ability to drive well, their sense of humor, and their certainty that "they are absolutely right" about specific things.[10]

WHY IT COULD BE A PROBLEM

This bias can lead us to believe we can accurately time the market (even though markets are unpredictable).[10]

HOW YOU CAN HELP PREVENT IT

Before making investing decisions or strategy changes, especially impulsive ones, consider doing some additional research or talk your ideas through with family, friends or a professional.

BIAS NO. 4: Recency Bias

WHAT IT IS
A tendency to place too much emphasis on experiences that are freshest in your memory — even if they are not the most relevant or reliable.[11]

WHAT IT CAN LOOK LIKE
The financial crisis in 2008 and 2009 led investors to exit the stock market. Many had a dismal view of the markets and likely expected more economic hardship in the coming years. The experience of having gone through such a negative event increased their bias toward the belief that the event could recur. In reality, the economy recovered, and the market bounced back in the following years.[11]

WHY IT COULD BE A PROBLEM
Recency bias can lead you to buy near the top during market runups and sell at the bottom during downturns.[11]

HOW YOU CAN HELP PREVENT IT
Take some simple measures, such as looking at historical events to understand the financial market, have a clear goal in mind, and work with knowledgeable professionals to help bypass recency bias to some extent and build a strong portfolio.

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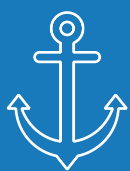


BIAS NO. 5: Anchoring Bias

WHAT IT IS
Slow reaction to economic, corporate or market developments because of an illogical or emotional attachment to a perceived value, even in the face of changing information.[12]

WHAT IT CAN LOOK LIKE
There are many real life anchors in the world of investing. Individual investors create anchors about their investment expectations based on news ("Gold nearing its year-to-date high") or talking to colleagues ("I have doubled my money on cryptocurrency").[12]

WHY IT COULD BE A PROBLEM
The anchors our brains choose often have no bearing on the decision to be made. For example, whether it makes sense to buy a fund at a given price depends on factors such as your financial situation, the fund's strategy, and future prospects. The price your friend bought at is completely irrelevant.[12]

HOW YOU CAN HELP PREVENT IT
When making an investment decision, consider the source of the recommendation. Are your circumstances similar? Is the timing and valuation still the same? Most importantly, would this choice support your personal goals? Thinking through these questions could help you decide whether it's really an appropriate investment for you.

BIAS NO. 6: Herd Mentality Bias

WHAT IT IS
Herding is when people follow the crowd instead of their own instincts and/or analysis.[13]

WHAT IT CAN LOOK LIKE
In a well-known study, participants were asked to answer a question by a show of hands (so that everyone in the group could see how everyone else was answering). In the first part of the test, the answer was obvious, and everyone got it right. But in the second part, there were "plants" in the group who intentionally answered incorrectly — and guess what? More participants got the answer wrong, a classic example of herding, where people might be lazy, indifferent or question their own judgment.[13]

WHY IT COULD BE A PROBLEM
The crowd is often wrong, and trends can be short-lived.[13] When it is, the repercussions can be costly: Think internet stocks in 2001 or meme stocks in 2021.

HOW YOU CAN HELP PREVENT IT
There is something to be said about the belief that there is safety in numbers — but when it comes to investing decisions, everyone's situation is unique and personal. While it can be tempting to jump on a bandwagon, review your existing strategy and remind yourself you have a plan to reach your goals — an impulsive change may end up hindering you in the long run.

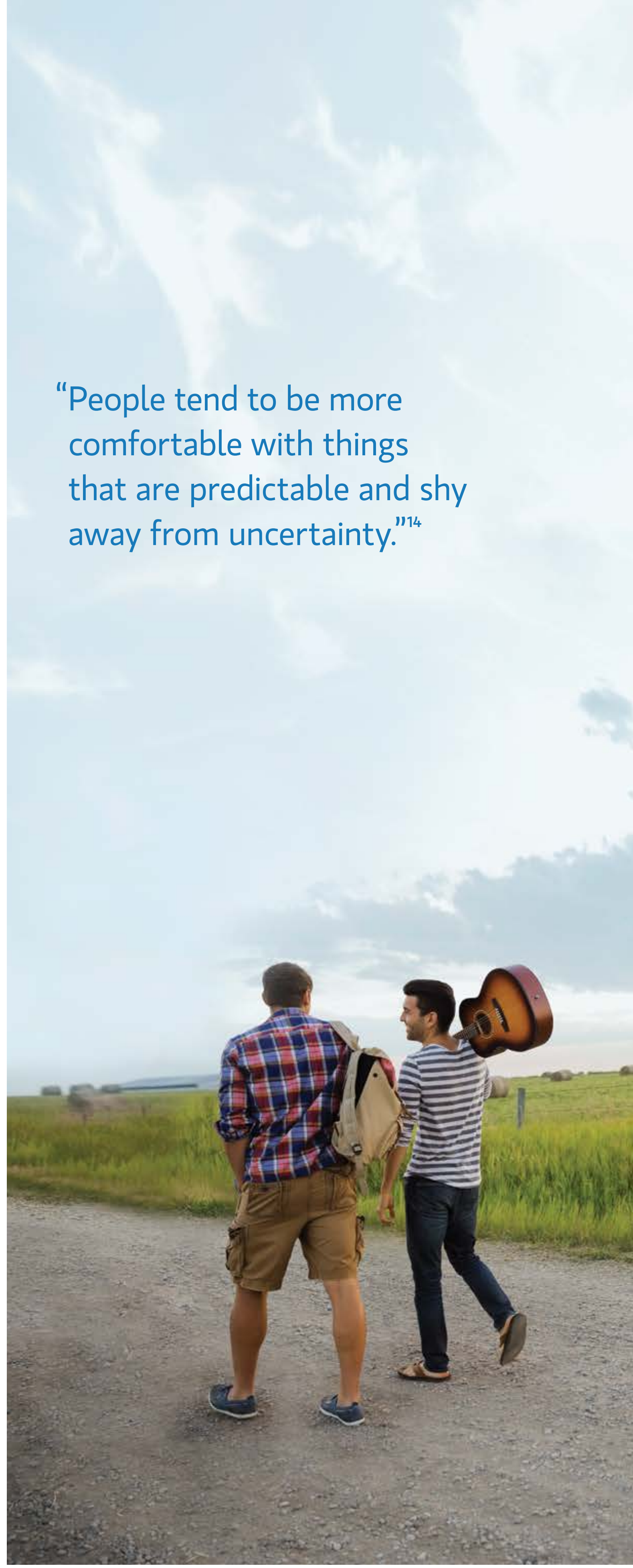
BIAS NO. 7: Ambiguity Aversion

WHAT IT IS
People tend to be more comfortable with things that are predictable and shy away from uncertainty.[14]

WHAT IT CAN LOOK LIKE
You might be tempted to load up on investments that offer predictable returns — like money market funds or bonds with a fixed rate of return — versus a growth stock with no dividend and uncertain returns. Alternatively, the fear of unknown outcomes could prevent you from making any decision at all, keeping you entirely out of the markets and missing out on potential opportunities.[14]

WHY IT COULD BE A PROBLEM
Sometimes sticking to your comfort zone is risky. For example, if your goal is to grow your money over a long time period, investments with predictable returns might not give you the best chance to achieve your goals.

HOW YOU CAN HELP PREVENT IT
Start with defining your short- and long-term goals, and then laying out multiple choices for how you could work to achieve them in a methodical, organized way. This approach can help you get a better sense of your options. Plus, speaking with a professional about these ideas can also help you develop a holistic plan you will feel comfortable with.



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The Bottom Line

None of us can be at our best alone, which is why professional financial advice can deliver added value. No matter the size of your portfolio, Financial Advisors at Morgan Stanley Virtual Advisor have the expertise to provide tailored guidance and education to help you overcome unconscious investing biases and make the most of your wealth.

Consult a Financial Advisor today.

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CRC 5537289 04/23 CS 619598-3174306 05/23