talk money with Ecstra Foundation

Finance facts: Investment biases

The importance of understanding investment biases in decision-making

The way we think and feel influences our financial decision-making in several ways. Some of these influences are well known in psychology and are categorised as 'behavioural biases'. Exploring these behavioural biases allows us to learn how to manage our money better, which can lead to financial stability and success in the long run.

Behavioural biases can cause us to think and act in ways that might not always be the smartest or most logical. There are two categories of behavioural biases: cognitive and emotional. While many cognitive and emotional biases are listed below, there are many more than this!

What are cognitive biases?

Cognitive biases affect how we think, remember, and make choices every day. For example, when deciding between snack purchases at the store, you might be attracted to the brightest packaging even though it is not the best value for money or healthiest choice. Here are a few cognitive biases that affect the way we spend and save money:

- **Overconfidence bias** happens when people think they know more than they do or believe they are better at something than they are. For example, you have done well on a recent math test, and you feel like you don't need to study as much for the next one, so you end up not doing as well as you expected
- **Confirmation bias** occurs when people seek out or remember information that confirms what they already believe and ignore information that contradicts their beliefs. For example, if someone thinks a certain brand is the best, they might only pay attention to positive reviews and overlook any negative ones
- **Anchoring bias** occurs when people rely too heavily on the first piece of information they receive when making decisions. For example, if a person sees a car they want for $20,000 (the anchor), but this was unusually cheap, and it sold quickly, they might perceive the prices on the same car in other car yards to be too high in comparison. They delay buying the car they want even if those prices are reasonable or the first price they saw was too low
- **Availability bias** happens when we base our judgements on information that is readily available in our minds, often from recent or memorable events. For example, hearing about a shark attack on the news makes it seem like a common danger, so you stop swimming in the ocean, even though the chance of a shark attack is extremely low.

What are emotional biases?

Emotional biases affect our ability to think clearly and lead us to make choices that might not be the most sensible or rational—for example, staying up late at a party before an important test because you were excited and didn't want to miss out. Emotional biases include:

- **Loss aversion** is the tendency to take action to avoid losing. For many of us, losing $10 feels worse than gaining the same amount feels good. This can lead to overly cautious decisions. For example, a friend can offer you a trade (lunch, collector cards, etc), where you would be better off taking the trade. Despite this, you are reluctant to part with your item because you don't want to feel the loss of something you currently own
- **Fear of missing out (FOMO)** is the fear that others are having more fun or experiencing better things than you are, leading to the urge to participate in activities or buy things to keep up and feel like you belong. For example, someone might buy a trendy and expensive water bottle because they see everyone else has one, even if they don't need it or can't afford it (and it makes no logical sense to spend $70 on a water bottle when you can buy one for $2 quite easily!)
- **Greed** is the intense desire for more wealth or possessions, often more than a person needs. It can drive people to take chances to get rich quicker. For example, in an online game, another player offers you a rare item in exchange for in-game currency that you recognise is overpriced based on experience. The offer is so alluring that you take it and then regret it later because all your in-game currency is gone. You are unhappy with what you have and are driven to add more in-game currency. It is likely that you will still be unhappy even when you get more in-game currency and are able to buy more things
- **Regret aversion** is when we avoid making decisions that might lead to regret, even if they could be beneficial in the long run. For example, you are offered money by a trusted adult to start a new business with an idea you shared. Despite the potential for the business to go well, you pass on the opportunity because you want to avoid the regret you would feel if your business didn't go well
- **Status quo bias** is when we prefer things to stay the same and resist change, even if change might be better. Status quo bias might affect someone who separates their cash into different envelopes to help with saving for bills instead of using her online bank account that lets her set up labelled sub-accounts to do the same thing. If she left her money in her bank account, she would earn some interest.

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Case study: Fear of Missing Out (FOMO)

Amira follows a bunch of influencers who talk about investing and making "easy money" from trending stocks and crypto. One day, she sees a post about a new company that's "about to explode" in value. Everyone in the comments is hyping it up, saying things like "don't miss out!" and "this is the next big thing!"

Even though Amira hasn't done much research and doesn't really understand what the company does, she feels pressure to act quickly—what if she misses her chance to make money?

She decides to invest her savings without checking if the company is trustworthy or thinking about the risks.

A few weeks later, the stock drops in value. It turns out the hype wasn't backed up by real information. Amira feels disappointed and realises she made the choice because she didn't want to feel left out.

This is an example of FOMO—Fear of Missing Out. Amira didn't want to miss the opportunity others were talking about, so she rushed into a decision without doing her own research. FOMO can lead to risky decisions and make people invest based on emotion instead of facts.

Strategies for minimising biases

By implementing these simple strategies, you can make more thoughtful and rational choices and minimise the adverse impacts of cognitive and behavioural biases.

Tips for minimising cognitive biases

1. **Awareness**—when making decisions, pause and ask yourself if any biases might be at play, like relying too heavily on the first piece of information you received
2. **Seek diverse perspectives:** before deciding, discuss it with friends or family members who may offer different insights or experiences
3. **Consider alternative options:** when faced with a choice, brainstorm several possible courses of action and weigh the pros and cons of each before deciding.

Tips for minimising emotional biases

1. **Emotional regulation:** if you're feeling anxious about a decision, take a few deep breaths and focus on calming your mind before proceeding
2. **Utilise decision-making tools:** before making a big decision, create a checklist of key criteria or questions to help you evaluate your options
3. **Set decision-making rules:** establish rules or guidelines for your spending. For example, decide on the maximum amount of money you are willing to spend on non-essential purchases and stick to it to avoid overspending.

Glossary

Bias	is a reference to a particular person, subject or thing, and contains more information that supports a particular stance than you would expect to find if all information is considered.
Rational	is based on or in accordance with reason or logic. A rational person is someone who is sensible and is able to make decisions based on intelligent thinking rather than on emotion.

Related Talk Money fact sheets

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Links

The Decision Lab—list of biases

About Talk Money with Ecstra Foundation: Talk Money with Ecstra Foundation is designed to help Australian students learn money lessons for life, to be confident talking about money and to make informed financial decisions. We offer facilitator led workshops for Years 5-10 students and additional resources to reinforce learnings. The program is provided at no cost to schools, enabling more students across Australia to access financial education at key life stages.

About Ecstra: Ecstra Foundation is an independent charitable foundation committed to building the financial wellbeing of Australians within a fair financial system. Ecstra launched Talk Money in February 2022.

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