How to Avoid The Five Psychological Pitfalls in Investing

Successful investing requires constant learning and paying meticulous attention to market movements. However, technical knowledge alone is not enough – psychology also plays an important role. In this issue, we highlight five psychological traps in investing and look at ways to avoid them.

Don't be blinded by herd mentality – Stay focused on risk

Herd mentality: Blindly following investment trends. To resist herd mentality, members must evaluate investment strategies independently through their own knowledge and common sense rather than following the mob.

Self-serving bias: It is human nature to do things that benefit oneself and to reject responsibility for mistakes. Investors with this bias tend to listen only to advice aligned with their own beliefs and ignore opposing opinions. Likewise, people often attribute investment success to their own decisions while blaming losses on market inefficiencies or erroneous advice. Avoid this bias by listing out the pros and cons of each investment decision to weigh between risk and return. And be careful not to over-emphasise returns.

Fundamentals – The main driving force behind price movements

Gambler's Fallacy: The mistaken belief that, after the occurrence of a random event, the chance of it happening again diminishes. For example, when you flip a coin 10 times and get 10 'heads' in a row, you may think that the next result would probably be a 'tail'. However, the probabilities of 'head' and 'tail' actually stay the same, at 50%, no matter how many times you toss a coin. Similarly, if the stock market declines consecutively for several days or months, investors may believe that the market will bottom out and rebound soon. But like the outcome of gambling, this is not justified by facts. The most decisive factors that drive the uptrend in asset prices are fundamentals, such as the economic outlook of a region and the profitability of corporations.

Past performance should not affect subsequent judgement

Anchoring: Basing important decisions on information that is irrelevant to the investment opportunity. For example, if the stock market previously hit bottom at 18,000 points, members may wait until the index hits 18,000 points again before re-entering the market – that is, 18,000 points becomes the anchor. Anchoring also affects how gains and losses are interpreted. If an investment portfolio starts with HK$1 million and climbs to HK$1.5 million before retreating to HK$1.1 million, many people may mistakenly think that the portfolio has lost HK$400,000. Some investors may even insist on holding on to the portfolio until it returns to the anchor of HK$1.5 million. When making investment decisions what matters most is the present circumstance, so it is important to "let go of the past".

Don't get sidetracked by losses

Loss aversion: An unwillingness to stop-loss after committing to a certain investment. A loss-aversion mentality may escalate the magnitude of losses or cause investors to miss out on attractive investment opportunities with better return potentials. To address this, investors can establish a stop-loss mechanism before committing to any investments, such as selling the stock once its share price drops 10% below the purchase price. In MPF investments, meanwhile, dollar-cost averaging means that more fund units will be purchased when the market fails to perform. Members should not be swayed by short-term market swings – if the long-term investment prospects stay intact, you are advised to continue with your investments. However, if the risk level no longer suits your risk appetite, then, even if the investment is making a loss, you should cut your losses by selling your stake.