How Good Investors Can Make Better Investment Decisions

That last decision you made about money: was it rational? Irrational? Or just normal (a little bit of both?)

If you are wondering what the heck this question even means, it means you're probably normal. Otherwise, you're probably an economist. Either way, the question can open doors into understanding how human behavior can hamper investment returns and how investors can do better.

Rational economists start from the view that we humans, at least on average across large numbers of us, act as though we consider all information and make correct decisions about our money in a thoroughly rational way, free of all emotion. In this view it becomes possible to create mathematical models to predict how an economy might play out if something changes. Financial professionals build on this idea to value investments and construct portfolios.

Behavioral economists say that the assumption of rationality doesn't fully explain what actually happens, and have amassed a large body of evidence that we act not only emotionally but irrationally quite often. People lacking financial and behavioral knowledge might hurt their investment returns by trading too often or paying too much, or simply by failing to plan effectively for their future well-being.

BCE Limited spans across this intellectual divide. It turns out that investors usually combine both reason and gut-feelings or emotion in their decisions, although too much of any of these approaches can sometimes lead to mistakes.

Being overly rational can keep someone from ever making a decision, an affliction called "paralysis by analysis." Normal people employ gut feelings and emotions successfully when they make a good-enough decision quickly. That is, they use their "blink system" rather than their "think system" to decide.

Gut-feelings and emotions can lead investors astray in two ways: by entering into investments that are likely to hurt them, and by avoiding investments that are likely to help them. A growing body of research makes it clear that we humans are a lot less rational than we like to think we are when it comes to money.

BCE Limited explains that investors can learn to use financial and behavioral knowledge to improve their decisions.

For example, behavioral knowledge can help an investor recognize when the so-called confirmation bias can be blinding them to financial facts about the valuation of a stock. No tree grows to the sky, but that can be hard to keep in mind when you want to believe you've found Jack's Magic Beanstalk. And that's normal.

Normal people may be able to avoid buying a good company's stock at a bad price by recognizing the need to switch momentarily from the blink system to the think system. Imagine it's five years later. Look back at today for available facts that could explain why the investment turned out badly.