Cognitive vs. Emotional Investing Bias: An Overview

Everybody has [biases](https://www.investopedia.com/terms/b/bias.asp). We make judgments about people, opportunities, government policies, and of course, the markets. When we analyze our world with our own biases, we put our observations through a number of filters manufactured by our experiences, and we're not just talking about [stock screeners](https://www.investopedia.com/terms/s/stockscreener.asp). We're talking about the filters we put our decisions through that sometimes make them biased. Individuals may or may not necessarily rationalize that their decisions are being made based on biases they have developed.

In general, all kinds of day-to-day activities are primarily driven by behavioral patterns. These same behavioral patterns can also influence investing actions.

For most people, it is impossible to be unbiased in investment decision-making. However, investors can mitigate biases by understanding and identifying them, then creating trading and investing rules that mitigate them when necessary. Broadly, investing biases fall into two main categories: cognitive and emotional. Both biases are usually the result of a prejudice for choosing one thing over the other.

**What Is Cognitive Bias?**

Cognitive biases generally involve decisionmaking based on established concepts that may or may not be accurate. Think of a cognitive bias as a [rule of thumb](https://www.investopedia.com/terms/r/rule-of-thumb.asp) that may or may not be factual.

We’ve all seen movies where a thief wears a police uniform to pass through a security checkpoint. The real police officers assume that because the person is wearing a uniform like theirs, he must be a real police officer. That’s an example of a cognitive bias.

What does a fake cop have to do with your investment choices? You make the same types of assumptions that may or may not necessarily be true. Here are some examples:

* **Confirmation Bias:** Have you noticed that you put more weight into the opinions of those who agree with you? Investors do this too. How often have you analyzed a stock and later researched reports that supported your thesis instead of seeking out information that may poke holes in your opinion?

### Understanding Confirmation Bias

Confirmation bias can create problems for investors. When researching an investment, someone might inadvertently look for information that supports his or her beliefs about the investment and fail to see the information that presents different ideas. The result is a one-sided view of the situation. Confirmation bias can thus cause investors to make poor decisions, whether it’s in their choice of investments or their buy-and-sell timing.

Confirmation bias affects perceptions and decision making in all aspects of life and can cause investors to make less-than-optimal choices. Seeking out people and [publications](https://www.investopedia.com/articles/investing/112514/top-sites-latest-stock-market-news.asp) with alternative opinions can help overcome confirmation bias and assist in making better-informed decisions.

This phenomenon is a source of investor overconfidence and helps explain why the bulls tend to remain bullish, and the bears tend to remain bearish regardless of what is happening in the market. Confirmation bias helps explain why investors do not always behave rationally and perhaps supports arguments that the market behaves inefficiently.

### Example of Confirmation Bias

Suppose an investor hears a rumor that a company is on the verge of declaring [bankruptcy](https://www.investopedia.com/terms/b/bankruptcy.asp). Based on this information, the investor considers selling the stock. When they go online to read the latest news about the company, they read only the stories that confirm the likely bankruptcy scenario and miss a story about a new product the company has just launched that is expected to perform well and increase sales. Instead of holding the [stock](https://www.investopedia.com/terms/s/stock.asp), the investor sells it at a substantial loss just before it turns around and climbs to an all-time high.

### Overcoming Confirmation Bias

**Seek Contrary Advice:** The first step to overcoming confirmation bias is to have an awareness that it exists. Once an investor has gathered information that supports their opinions and beliefs about a particular [investment](https://www.investopedia.com/terms/i/investment.asp), they should seek alternative ideas that challenge their point of view. It is good practice to make a list of the investment’s pros and cons and reassess it with an open mind.

**Avoid Confirming Questions:** Investors should not ask questions that confirm their conclusions about an investment. For example, an investor who wants to buy a stock because it has a low [price-earnings (P/E) ratio](https://www.investopedia.com/terms/p/price-earningsratio.asp) would be confirming their findings if they only asked their financial advisor about the company’s valuation. A better approach would be to ask the broker for more information about the stock, which can be pieced together to form an unbiased conclusion.

* **Gamblers’ Fallacy:** Let’s assume that the S&P has closed to the [upside](https://www.investopedia.com/terms/u/upside.asp) five [trading sessions](https://www.investopedia.com/terms/t/tradingsession.asp) in a row. You place a short trade on the SPDR S&P 500 (SPY) because you believe chances are high that the market will drop on the sixth day. While it may happen, on a purely statistical basis, the past events don’t connect to future events. There may be other reasons why the sixth day will produce a down market, but the fact that the market is up five consecutive days is irrelevant.
* Also known as the Monte Carlo Fallacy, the Gambler's Fallacy occurs when an individual erroneously believes that a certain random event is less likely or more likely, given a previous event or a series of events. This line of thinking is incorrect because past events do not change the probability that certain events will occur in the future.

### BREAKING DOWN Gambler's Fallacy/Monte Carlo Fallacy

* This line of thinking in a Gambler's Fallacy/Monte Carlo Fallacy represents an inaccurate understanding of probability. This concept can apply to [investing](https://www.investopedia.com/terms/i/investing.asp). Some investors [liquidate](https://www.investopedia.com/terms/l/liquidate.asp) a position after it has gone up after a long series of [trading sessions](https://www.investopedia.com/terms/t/tradingsession.asp). They do so because they erroneously believe that because of the string of successive gains, the position is now much more likely to decline.

### Example of the Gambler's Fallacy/Monte Carlo Fallacy

* For example, consider a series of 10 coin flips that have all landed with the "heads" side up. Under the Gambler's Fallacy, a person might predict that the next coin flip is more likely to land with the "tails" side up.
* The likelihood of a fair coin turning up heads is always 50%. Each coin flip is an independent event, which means that any and all previous flips have no bearing on future flips. If before any coins were flipped a gambler were offered a chance to bet that 11 coin flips would result in 11 heads, the wise choice would be to turn it down because the probability of 11 coin flips resulting in 11 heads is extremely low. However, if offered the same bet with 10 flips having already produced 10 heads, the gambler would have a 50% chance of winning because the odds of the next one turning up heads is still 50%. The fallacy comes in believing that with 10 heads having already occurred, the 11th is now less likely.
* **Status-Quo Bias:** Humans are creatures of habit. Resistance to change spills over to investment portfolios through the act of repeatedly coming back to the same stocks and ETFs instead of researching new ideas. Although investing in companies you understand is a sound [investment strategy](https://www.investopedia.com/terms/i/investmentstrategy.asp), having a short list of go-to products might limit your profit potential.
* **Risk-Averse Bias:** The [bull market](https://www.investopedia.com/terms/b/bullmarket.asp) is alive and well, yet many investors have missed the rally because of the fear that it will reverse course. Risk-averse bias often causes investors to put more weight on bad news than good news. These types of investors typically overweight in safe, conservative investments and look to these investments more actively when markets are rocky. This bias can potentially cause the effects of risk to hold more weight than the possibility of reward.
* Loss aversion is an important concept associated with [prospect theory](http://www.behavioraleconomics.com/prospect-theory/) and is encapsulated in the expression “losses loom larger than gains” (Kahneman & Tversky, 1979). It is thought that the pain of losing is psychologically about twice as powerful as the pleasure of gaining. People are more willing to take risks (or behave [dishonestly](http://www.behavioraleconomics.com/resources/mini-encyclopedia-of-be/honesty/); e.g. Schindler & Pfattheicher, 2016) to avoid a loss than to make a gain. Loss aversion has been used to explain the [endowment effect](http://www.behavioraleconomics.com/endowment-effect/) and [sunk cost fallacy](http://www.behavioraleconomics.com/sunk-cost-fallacy/), and it may also play a role in the [status quo bias](http://www.behavioraleconomics.com/status-quo-bias/).
* The basic principle of loss aversion can explain why penalty [frames](http://www.behavioraleconomics.com/framing-effect/) are sometimes more effective than reward frames in motivating people (Gächter et al., 2009) and has been applied in behavior change strategies.
* People’s cultural background may influence the extent to which they are averse to losses (e.g. Wang et al., 2017).

**Bandwagon Effect:** Warren Buffett became one of the most successful investors in the world by resisting the [bandwagon effect](https://www.investopedia.com/terms/b/bandwagon-effect.asp). His famous advice to be greedy when others are fearful and fearful when others are greedy is a denouncement of this bias. Going back to [confirmation bias](https://www.investopedia.com/terms/c/confirmation-bias.asp), investors feel better when they are investing along with the crowd. But as Buffett has proven, an opposite mentality, after exhaustive research, may prove more profitable.

The bandwagon effect refers to the tendency people have to adopt a certain behavior, style, or [attitude](https://www.verywellmind.com/attitudes-how-they-form-change-shape-behavior-2795897) simply because everyone else is doing it. The more people that adopt a particular trend, the more likely it becomes that other people will also hop on the bandwagon.

The bandwagon effect is part of a larger group of [cognitive biases](https://www.verywellmind.com/what-is-a-cognitive-bias-2794963) or errors in thinking that influence the judgments and [decisions](https://www.verywellmind.com/decision-making-strategies-2795483) that people make. Cognitive biases are often designed to help people think and reason more quickly, but they often introduce miscalculations and mistakes.

### Examples of the Bandwagon Effect

* **Fashion:** Many people begin wearing a certain style of clothing as they see others adopt the same fashions.
* **Music:** As more and more people begin listening to a particular song or musical group, it becomes more likely that other individuals will listen as well.
* **Social Networks:** As increasing numbers of people start using certain online social networking websites, other individuals become more likely to begin using those sites as well. The bandwagon effect can also influence how posts are shared as well as interactions within online groups.
* **Diets:** When it seems like everyone is adopting a certain fad diet, people become more likely to try the diet themselves.
* **Elections:** People are more likely to vote for the candidate that they think is winning.

### Influential Factors

So, why exactly does the bandwagon effect occur? Individuals are highly influenced by the pressure and norms exerted by groups. When it seems like the majority of the group is doing a certain thing, not doing that thing becomes increasingly difficult. This pressure can impact many different aspects of behavior, from what people wear to who they vote for in political races.

Some of the factors that can influence the bandwagon effect include:

#### Groupthink

The bandwagon effect is essentially a type of [groupthink](https://www.verywellmind.com/what-is-groupthink-2795213). As more people adopt a particular fad or trend, the more likely it becomes that other people will also "hop on the bandwagon." When it seems that everyone is doing something, there is a tremendous pressure to [conform](https://www.verywellmind.com/what-is-conformity-2795889), which is perhaps why the bandwagon behaviors tend to form so easily.

#### A Desire to Be Right

People want to be right. They want to be part of the winning side. Part of the reason people conform is that they look to other people in their social group for information about what is right or acceptable. If it seems like everyone else is doing something, then people are left with the impression that it is the correct thing to do.

#### A Need to Be Included

Fear of exclusion also plays a role in the bandwagon effect. People generally do not want to be the odd one out, so going along with what the rest of the group is doing is a way to ensure inclusion and social acceptance. The [need to belong](https://www.verywellmind.com/what-is-the-need-to-belong-2795393) pressures people to adopt the norms and attitudes of the majority to gain acceptance and approval from the group.

While the bandwagon effect can be very powerful and leads to the ready formation of trends, these behaviors also tend to be somewhat fragile. People jump on the bandwagon quickly, but they also jump off it just as fast. This is perhaps why trends tend to be so fleeting.

### Negative and Dangerous Effects of the Bandwagon Effect

The impact of these bandwagon trends is often relatively harmless, such as in fashion, music, or pop culture fads. Sometimes they can be far more dangerous. When certain ideas begin to take hold, such as particular attitudes toward health issues, bandwagon beliefs can have serious and damaging consequences.

Some negative or even dangerous examples of the bandwagon effect:

* Individuals who were influenced by the anti-vaccination movement, for example, became less likely to get routine childhood immunizations for their children. This large-scale avoidance of vaccinations has been linked to a recent measles outbreak.
* Researchers have found that when people learn that a particular candidate is leading in the polls, they are more likely to change their vote to conform to the winning side. In one study carried out during the 1992 U.S. presidential election, students who learned that Bill Clinton was leading the race in some polls switched their intended vote from Bush to Clinton.

While the bandwagon effect can have dangerous consequences, it can also lead to the adoption of healthy behaviors. If it seems that the majority of people reject unhealthy behaviors (such as smoking) and embrace healthy choices (such as exercising and working out), people may then become more likely to avoid risky choices and engage in healthy actions.

**What Is Emotional Bias?**

Emotional biases typically occur spontaneously based on the personal feelings of an individual at the time a decision is made. They may also be deeply rooted in personal experiences that also influence decisionmaking.

Emotional biases are usually ingrained in the psychology of investors and can generally be harder to overcome than cognitive biases. Emotional biases are not necessarily always errors. In some cases, an investor’s emotional bias may help them to make a more protective and suitable decision for themselves.

Here are a few examples:

* **Loss-Aversion Bias:** Do you have a stock in your portfolio that is down so much that you can’t stomach the thought of selling? In reality, if you sold the stock, the money that is left could be reinvested into a higher-quality stock. But because you don’t want to admit that the loss has gone from a computer screen to real money, you hold on in hopes that you will, one day, make it back to even.
* **Overconfidence Bias:** “I have an edge that you (and others) do not.” A person with overconfidence bias believes that his/her skill as an investor is better than others' skills. Take, for example, the person who works in the pharmaceutical industry. He/she may believe in having the ability to trade within that [sector](https://www.investopedia.com/terms/s/sector.asp) at a higher level than other traders. The market has made fools out of the most respected traders. It can do the same to you.
* **Endowment Bias:** Similar to loss aversion bias, this is the idea that what we do own is more valuable than what we do not. Remember that losing stock? Others in its sector may show more signs of health but the investor won’t sell because he/she still believes, as before, it’s the best in its sector.