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The Impact of Human Misjudgment Psychology on Investing

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Everyone responds to their psychological emotions, which affects all aspects of their lives. Therefore, psychology is not an independent discipline; it can react chemically with many other disciplines, such as finance and architecture. A person who is not careful and unconcerned about precision is more likely to fail a project. Investment decision-making always appears in people's daily life and takes an important role. Through linking psychology to investment, people can learn a deep understanding on their investment decision. Human Misjudgment Psychology is a not widely taught discipline although it has great influence on the decision-making. As a result, the focus of this paper will be on the impact of Human Misjudgment Psychology on investment decisions. However, due to the limitation of time, only five biases from the Human Misjudgment Psychology will be covered, so further research and studies of the other biases will be looking forward to being finished.

Keywords: psychology, investment decision-making, Human Misjudgment Psychology, Munger

Introduction

People make numerous decisions every day, ranging from what to eat for breakfast to which investment decision to take. To make a correct investment decision, such as investing in a company, the investor may need to study and evaluate if the investment is necessary for execution using his or her own set of logical judgments, professional knowledge, and rules of thumb. In practice, however, human judgment is rarely totally rational, and it is frequently impacted by psychological variables, leading to irrational investment decisions.

Human Misjudgment Psychology is a field of psychology proposed by Munger that influences people's investment decisions. By understanding his worldly wisdom and the psychology of human misjudgment, investors can make better decisions. Many things that matter to people can be foreseen to shape the future by taking the actions they love. Understanding Munger's psychology of human misjudgment and approach will change the way people think about investing and life, leading to better investment decisions.

This paper will analyze the importance of psychology in human decision-making in the second section. The third section will introduce the psychology of human misjudgment and the fourth section will link the psychology of human misjudgment to investment decision-making. To get a more precise and in-depth understanding of the psychology of human misjudgment's impact on investing decisions, this paper selects five biases from the misjudgment to explain their own relationship with investing decisions. Finally, some conclusion will be given and some future research direction will be shown.

The Impact of Psychology on Investment Decisions

An individual investor's decision-making process can be considered as a continuous process that has a

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significant impact on their psyche when making investment decisions. Seasoned investors are not always superior to inexperienced investors. The psychological factor is not always having a lesser impact on seasoned investors than inexperienced investors. Gupta and Ahmed (2016) used discriminant analysis and the chi-square test to explore and analyze four behavioral biases, including loss aversion bias, regret aversion bias, sheep Group bias, and anchoring bias, on 380 investors. It was found that both groups exhibited conformity bias in equally likely ways. Additionally, experienced investors are more prone to loss aversion bias, regret aversion bias, and anchoring bias than less experienced investors. A risk-averse investor can also change his or her investment decisions due to psychological changes. Nofsinger (2017) points out that while conventional finance theory would suggest that most people would be risk averse and would rather not take risks, they would do so if the expected returns were sufficient. And it also argues that people should also be consistent in their level of risk aversion. However, in the reality, people often behave in ways that violate such theory. For example, people display risk aversion when buying insurance, while at the same time exhibiting risk-seeking behavior when buying lottery tickets. It is clear that people's investment decisions and their psychology are intertwined.

Human Misjudgment Psychology

Kuo (2010) mentions that Charlie Munger is the vice chairman of Berkshire Hathaway and a longtime partner of Warren Buffett. The psychology of human misjudgment was proposed by Munger in his speech. Charlie Munger (1995) listed 25 factors, such as: incentives, simple psychological denial, incentive-cause bias, bias from consistency and commitment tendency, misconstructing past correlation as a reliable basis for decision-making, bias from reciprocation tendency, lollapalooza, bias from contrast-caused distortions of sensation, perception and cognition, bias from over-influence by authority, bias from deprival super-reaction syndrome, bias from envy/jealousy, bias from chemical dependency, bias from mis-gambling compulsion, bias from liking distortion. In addition, he presented in lectures at Caltech and Harvard and published in a book called *Poor Charlie's Almanac*, with one chapter titled "The Psychology of Human Misjudgment". The next section of the article cites five of these biases to explain their impact on investor decision-making.

Incentives

To explain incentives, Munger used the FedEx case. The heart and soul of the integrity of the system lies in the rapid transfer of all packages to a central location every night. If the entire shift cannot be completed quickly, the entire system cannot smoothly get products to FedEx customers. FedEx employees screwed up all the time, never finished their tasks on time, and managers had tried everything—moral persuasion, threats, etc., to no avail. Finally, someone came up with a great way to lower the hourly rate but increase the pay per shift—once all the work is done, they can go home. This incentive approach solved the efficiency problem that had plagued the FedEx for a long time.

When analyzing the impact of incentives on investment decisions, take speculation as an example. When the market environment is hot, inexperienced investors will follow the trend and make decisions. When they are unsure if the decision is right or wrong, it has already started to make a profit. Although effective, there is a problem with this decision in fact. After being motivated by this decision, investors increase their bets and are often swallowed up by the market. It is like today's situation of "chasing up and down". This mechanism influences the outcome of investments.

Simple Psychological Denial

For simple psychological denial, Munger cited the example of a very rational mother who, when informed of her son's death, would rather believe that he was alive than dead, and also pointed out the mothers of the most evident criminals humans that man can ever diagnose on TV, who all believe their kids are innocent.

In investment decision-making, when there is a serious loss in an investment, although various evidences will point out that the investment decision is a failure, and not withdrawing in time may cause more serious losses, investors may believe that they will definitely return profitable again. The reality may be too painful for them to accept, and the investors distort it so that they can bear it, which is simple mental denial.

Bias From Consistency and Commitment Tendency

Hornik (1972) states the Balanced Model of Social Influence. It examines a triad of three relationships, namely, a person's evaluation of himself, his perception of others' evaluation of him, and his evaluation of others. These triplets tended to be balanced when individuals made explicit behavioral commitments in experiments, and initially more triplets were unbalanced than balanced. In the experiment, subjects who were led to believe that they had made a behavioral commitment would exhibit balanced triads consistent with their apparent commitment and self-assessment of experimentally manipulated task abilities. And conclude that the individual will tend to remain committed to his initial response, especially in the case of a public commitment.

Bias from consistency and commitment tendency includes the tendency to avoid or quickly resolve cognitive dissonance. A tendency to self-affirm includes all conclusions, especially those expressed, as well as a particular insistence on hard-won conclusions. When people have their own set of investment systems that they think are successful, and if the outside world changes and impacts their current investment system, people tend to avoid such things that are contrary to or deviate from their investment perceptions, stick to their investment system, and do not make changes, or once they make some painstaking investment decisions, they tend to stay consistent with the original decision and not make changes.

Misconstructing Past Correlation as a Reliable Basis for Decision-Making

Aarts, Verplanken, and Van Knippenberg (1998) mention that in the conventional view of habit formation, satisfying experiences enhance the tendency to repeat the same behavioral process because instrumental behaviors are so strongly associated with the goals that people initially hope to achieve. The stronger the association, the stronger the relation between goals and instrumental behavior. Conversely, dissatisfaction weakens the link between the goal and the behavior, reducing the likelihood that a person will continue the behavior. Thus, people tend to instrumentally repeat the same behavior when faced with a similar situation if they have had a satisfying experience in the past.

Similarly, when people have a period of investment experience, people may naturally become more cautious the next time they encounter the same investment environment and directly use the previous methods which are practiced in the last experience. It's comparable to a dependence on past, inferring the future through history, but it's highly possible that this is merely a surface similarity, and blindly copying and mimicking may not yield the same results. Rather, it results in losses. When it comes to investing in a company, if profits and dividends have been high in prior years, investors may subconsciously assume that it will continue to be profitable in the future and accept a firm's past performance as a predictor of future performance. So objective, it may ignore many objective unfavorable factors which will affect the investment results.

Bias From Over-Influence by Authority

An expert is someone who is considered likely to be experienced in the relevant matter and use their knowledge to serve or give people advice. In modern society, it is not only nations and large corporations that use knowledge-based careers to serve; on the contrary, groups and individuals seek advice in almost all situations in life, not only in day-to-day matters, but also in very personal ones. Experts obviously play multiple roles and perform various functions. For example, they are called upon to act as risk managers, referees, judges, or advisors who can impart knowledge. Whatever role they may be asked to play from one setting to another, people are interested in how experts can provide specific serve with them underlying social conditions. Thus, the authority experts have can have a great influence on people's perceptions.

This is a very common issue in investment. There are various experts in the market and various industries. They have studied and taken root in different fields. For junior investors, these experts' words have weight with junior investors. It is a symbol of over-reliance due to lack of professionalism and blindly following the investment advice of so-called experts. If these so-called experts in the investment field express their optimism about a certain industry, a certain stock, or a certain fund, they will buy it blindly, and this kind of thoughtless following is also a large part of the reason why they make poor investment decisions.

Conclusion

Psychology is a significant field, and investing is a growingly popular pastime. The two interact and have a behavioral impact on investors when combined. This paper explains the influence of psychology on investment decisions. However, psychology has many fields and branches; each of them can have impact on human investment decision-making. Since the psychology of human misjudgment is a small and novel field of psychology, the people who study it are not mainstream. Most importantly, this is proposed by the famous investment guru Munger. Hence, this paper chooses the psychology of human misjudgment and uses it to illustrate people's investment decisions. Due to the limitation of time, this paper only picks five psychological biases from the Human Misjudgment Psychology system to explain the likely impact of them on people's investment decisions.

Since this paper just explains five biases and associate them with investment decisions when without stating other biases. Thus, more research and studies in discovering in other biases will be written in the future.

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