Understanding what drives your investment behaviour key to success

Investor behaviour sometimes defies logic. PHOTO | FOTOSEARCH

By SCOTT BELLOWS

Posted Wednesday, March 9 2016 at 18:17

In Summary

- Learn about cognitive dissonance and seek external advice before and during business decisions and activities.

The cataclysmic battle between capitalism and communism defined much of the late twentieth century.

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Capitalism proved more efficient at providing stable supplies of goods and services and increasing living standards. Communism, apart from being difficult to centrally manage, failed to identify, foster, and make use of basic elements of human psychology.

Communism only partially incorporated what truly motivates people. Personal gain, advancement, pride, stability, mastery, purpose, autonomy, trust, and community all deeply stimulate workers.

Historically, East Africans know the post-independence rivalry between Kenya and Tanzania during the same period as the former embraced more American-style capitalism and the latter Soviet-inspired socialism.

Many scholars attribute Kenya’s regional economic dominance in large part to our capitalistic orientation as well as a plethora of other antecedents and moderating variables, such as peace, freedoms, civil society, strong education system, etc.

While Karl Marx and later the Soviets misunderstood human motivation, China too reformed to produce its economic ascension after embracing post-Mao Tse-tung pro-capitalist, albeit controlled, policies.

As much as nations try to develop utopian societies based on magnificent theories, human psychological motivations are hard to change and can derail even the most desired outcomes.

So in the capitalist framework that now dominates the world economy, executives from Nairobi to Bishkek, Ulaanbaatar, and Tbilisi to Prague, Tunis, and Newcastle, to Lima, Shreveport, and St Louis try to accentuate positive organisational outcomes such as profitability, return on assets, sales growth,
employee retention and job satisfaction.

Organisational behaviourists research multitudes of data to determine the optimal causes that lead to the desirable effects that every executive wants for his or her firm.

Kurt Lewin famously devised the formula for behaviour in 1936 as: B=f(P/E). Behaviour is a function of both the person and the environment or system around them.

Part of human behaviour involves irrationality. Why do people sometimes act against their own interests?

Inasmuch, why do citizens vote for politicians who do not help their lives, from here in Kenya, to American Southern uninsured Republicans, to Russian nationalists struggling economically?

Why do students sometimes cheat on assignments even though completion of the projects would enhance their knowledge and employability?

Why do various people wait on some untested religious rituals to heal them instead of turning to medical science?

But we must build in human irrationality into our assumptions as leaders, managers, and parents. Psychologist Leon Festinger developed the theory of cognitive dissonance as a new theme in social psychology back in 1956.

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When two incompatible inconsistent observations are made by an individual, it produces a state of cognitive dissonance.

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Since dissonance is unpleasant, then the person seeks to diminish the feeling and therefore alters his or her belief. As an example, an employee who dislikes his boss but realises that she has helped boost his career will subsequently alter his previous negative view of his manager.

Ever since Festinger’s theory, executives, researchers, and policy makers utilise it to explain the otherwise unexplainable.
Dissonance can take time to build up in an individual and someone can hold two opposing views, such as the world being both flat and round at the same time for an uncomfortable period of time.

Behaviour and irrationality also impact the world of finance. Martin Sewell of Cambridge University delineates that behavioural finance looks at economics and finance through a combination of behavioural and cognitive psychological theory that provides explanations for why people make irrational baffling financial decisions.

Researchers Tom Chang, David Solomon, and Mark Westerfield set out to discover cognitive dissonance in people’s investment behaviour.

Strikingly, the research released in February this year shows that investors make poor decisions even against their own benefit.

When you hire a stock broker to select stocks for you and you monitor the portfolio that they build for you, if you see a large increase in your portfolio balance, you will likely tell your broker to sell the stocks so that you capture the capital gain as cash in your bank or pocket.

Likewise, when a sharp decline in the market occurs, you will instruct your stock broker to quickly move your money out of riskier stocks and into safer investments like treasury bills.

Strangely, when someone actively picks out his or her own stocks and trades them on a regular basis, they do not cash out and do not sell their poorly performing stocks.

They keep incurring greater and greater losses. But if a broker made the initial investment decisions, then an investor will tell the broker to sell early on and prevent possible future losses.

However, both an individual investor making decisions as well as a passive investor relying on a broker both sell high performing stocks to lock in profit.

Why would an investor keep holding on to a losing portfolio if he or she decided on the selection of those equities? The answer: cognitive dissonance.

Investors avoid realising losses and moving funds to safer investments because they dislike admitting that their own past purchases were mistaken.

When the decisions are delegated to a broker, the effect is reverses because the investor feels that they are allowed to blame the portfolio manager instead of themselves and therefore make faster better decisions.

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One may liken it to someone who is more willing to sell a home that a friend recommended to them rather than a home they sought out and investigated by themselves.

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When investing, be aware of your own behaviour and what drives it. Learn about cognitive dissonance and seek external advice before and during investing activities.

Increase your self-efficacy and awareness of dissonance so that it pushes you to act swiftly and more appropriately.

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Prof Scott serves as the Director of the New Economy Venture Accelerator (NEVA) and Chair of the Faculty Senate at USIU, www.ScottProfessor.com, and may be reached on: info@scottprofessor.com or follow on Twitter: @ScottProfessor.