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Behavioral finance

Beware of 'cognitive dissonance': It undermines facts, leads to poor investing decisions

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When we humans reach an opinion, we often stick to it no matter what. Psychological research shows that even a host of countervailing facts might not be able to budge us from that opinion one inch.

Let's look at this common phenomenon, known as cognitive dissonance, and how it can undermine facts and lead to poor investing decisions.

Cognitive dissonance is the mental discomfort we feel when new information conflicts with our previously held ideas or beliefs. It's a source of confirmation bias. Cognitive dissonance is also our tendency to seek, interpret or remember information that confirms our preconceptions.

It leads us – and please bear with me here – to engage in what's known as dissonance reduction. That is, we try to resolve our discomfort by tending to notice only information of interest to us. We ignore or modify information that conflicts with existing beliefs. And, we tend to consider or remember only the information that confirms our existing beliefs.

Most people try to avoid situations that give rise to cognitive dissonance. Some people will even ignore potentially relevant information to avoid the psychological conflict. They often rationalize to synchronize their beliefs and understandings, so as to maintain psychological stability.

Consider smokers. They almost certainly know that smoking is unhealthy. But they tend to ignore the evidence or minimize the likelihood that smoking could seriously affect them.

So, what has all this to do with investing?

Investors often go to great lengths to rationalize previous decisions on investments. This happens especially when those decisions were based on highly subjective factors. To protect their rationalized decisions, these investors may go so far as to avoid selling when the investment proves to be a mistake. This allows a losing investment to get even worse.

Cognitive dissonance may also prevent them from selling something they've made a profit on, even when it becomes overpriced, as in a stock bubble. Such bias may well be what kept people from selling their tech stocks in early 2000; or from selling their Las Vegas real estate in 2007, before prices collapsed.

Cognitive dissonance may also prevent investors from buying stocks they were previously negative about. This may happen even after conditions change or prices fall low enough to make the stocks worthwhile investments. For instance, very few people saw the financial crisis coming to the extent it did in 2008. And, of those few who happened to sell before the stocks fell, very few would have been able to change their minds quickly enough to buy back in when those same stocks hit their lows in early 2009.

What can you do to avoid the errors caused by cognitive dissonance?

When you feel uncomfortable about something: Stop. See if you can find the inner conflict. Be on the lookout for your behaviours and decisions whose main purpose is to reduce the mental discomfort you may feel about new information – and about opinions that conflict with your views.

Above all, don't become married to your beliefs. Don't become overconfident about their accuracy. Recognize that you are human and that almost any belief or opinion you hold could be contrary to the facts.

Try to adopt the view that it is a sign of wisdom and maturity to be able to admit you're wrong and to change your mind. Your portfolio will thank you. ■

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