Tip: Avoid current fashions and gurus, as well as making investment decisions based on rumours and secrets. Seek professional advice for your investment decisions and determine the extent of your responsibilities and freedom to trade on your own.

The **hyperbolic discount bias** is the tendency to choose smaller, immediate rewards over larger rewards in the distant future. The immediacy of payoffs has a greater power of attraction. Hyperbolic discount can lead investors to get rid of long-term investments that fit their profile, due to an upturn in the markets or the appearance of more profitable financial products, altering their initial objectives and incurring costs and associated risks.

Loss aversion is another prevalent bias and refers to the tendency to weigh losses more than gains. The fear of losing something acts as a greater incentive than the possibility of gaining something of similar value. For fear of incurring a loss, investors might hold onto poor investments with minimal prospects for recovery, and end up losing everything they invested.

This bias may lead to the so-called **myopic loss aversion**, especially detrimental to long-term investors, which causes them to continually assess the value of their portfolio and overreact to news and events that occur in the short term. Short-sightedness causes the investor to lose the perspective of their investments and the events that affect them.

Tip: Markets go up and down. Learn how to stay on track and not get distracted by daily fluctuations. Be consistent with the timeframes of your objectives and remember that it is wise to maintain a mix of investments with differents time horizons to be able to meet different needs as they arise.

"Making decisions is like speaking in prose—people do it all the time, knowingly or unknowingly."

Daniel Kahneman

CNMV
Comisión Nacional del Mercado de Valores

Investor Assistance:
900 535 015

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Edison, 4 • 28006 Madrid

Passeig de Gràcia, 19 • 08007 Barcelona

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Investor Fact Sheets

Psychological Mechanisms that Influence Our Investment Decisions

CNMV
Comisión Nacional del Mercado de Valores

Introduction

When making investment decisions, having the right information about the financial product you want to acquire is crucial. You should also take into account the psychological mechanisms involved: what mental processes you follow and what errors or biases in your way of thinking can influence your decisions. Numerous studies address this issue and try to highlight the psychological factors involved in decision-making.

How do we make decisions?

Daily life is a continuous decision-making process. Some decisions are trivial, like what to have for breakfast or how to get to work; others, such as what career to pursue or where to live, are transcendental. According to psychologists like Daniel Kahneman or Amos Tversky, to manage all these decisions and survive the required activity, the human brain unconsciously resorts to mental tricks or shortcuts (also called heuristics) that help simplify the enormous amount of mental processes constantly deployed, making our daily life more bearable.

Thanks to these tricks, the brain saves energy by not having to rationalize every choice it makes. Many of life's decisions use this type of mental shortcuts and are made quickly, automatically and by intuition.

You should understand the biases that affect your decision-making process; keep in mind that no one is exempt from them.

¿What biases might influence my investment decisions?

Here are some of the biases you may face as an investor, and recommendations to avoid or mitigate them.

One bias that may affect you most as an investor is the **overconfidence bias,** or the tendency to overestimate subjective knowledge and judgments and consider them facts. When making decisions and predictions, we tend to overvalue knowledge and personal experience without taking into account the gap between what we know and what we think we know. Overconfidence can lead investors to believe that the probability of their investment failing is less than it is. Overconfident investors underestimate their risks and overestimate their expected returns.

Tip: Know yourself as an investor. Although your financial intermediary will ask for information to get to know you better to help you with your investment decisions and provide the most appropriate services, you need to be sure that the risks you assume are compatible with your financial situation and your willingness to accept losses, should they occur.

The illusion of control refers to the tendency to overestimate our power to control or influence outcomes which are objectively beyond our control. This bias may lead to taking on a higher than adequate level of risk, thinking that market ups and downs can be controlled through analysis and available information.

Tip: Avoid excessive buying and selling in an attempt to "beat the market". It is relatively easy now to conduct speculative trades once reserved for the experts. This type of trading, however, carries a very high risk. Never compromise your money without understanding the investment and its risks, and remember that high return investments with no risk do not exist.

The so-called **confirmation bias** is one of most frequent; it consists of interpreting information on-hand or seeking new information to confirm previous convictions or ideas.

Investors with this bias selectively seek information to support their existing beliefs instead of considering contradictory opinions or reports, thus risking poor investment decisions.

Anchoring bias is the predisposition to give more weight to information obtained first than to newer, conflicting information. The name draws on the fact that pre-existing ideas sometimes act like anchors, difficult to release. In the investment world, this bias may exist when the return on an investment product is presented first, so that less positive aspects, like the associated risks, are overlooked. Another example is when an investor uses the past performance of a share to gauge its future evolution.

Tip: Get into the habit of using critical thinking to look for, solicit and read, in a timely fashion, all the official information that your intermediary must provide to help you make sound investment decisions.

Authority bias is the tendency to overestimate the opinions of certain people, just because of who they are, without question. Investors might make decisions based only on the recommendations or advice of a family member or friend, without further analysis and without taking into account their individual needs and risk profile.

On the other hand, the **halo effect** is the disposition to judge a person or institution by a single positive or negative quality that overshadows the rest. Very frequent in the investment world, the tendency is to rate a financial product as good or bad based on a single aspect, like the company's profits or the popularity of the product marketer or manager, without considering that the particular product may not fit the investor's intended investment objective or risk profile.

Social proof is the tendency to imitate other people's actions, believing that they represent optimal behaviour. This bias occurs when the subject has no definite idea of how to act and is guided by the conduct of others, assuming they have more knowledge. An investor who just does what others do might be influenced by their decisions and herded into an ill-fit investment.