

Enduring thoughts

The evolutionary trap: why humans are hardwired to be bad investors

Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.

Peter Lynch

Human beings are remarkably good at predicting movement. For most of our evolutionary history survival depended on it. A hunter who aimed where an animal was currently standing would go hungry. Success required anticipating where it would be a moment later and moving to intercept it.

Over thousands of generations our brain became exceptionally skilled at detecting patterns in motion and projecting them forward.

That same instinct is triggered when we look at a price chart.

A line on a graph looks like movement. The brain treats it the same as it would any moving object in the physical world.

When the line rises the brain instinctively projects the trajectory of the next point to sit higher still. When it turns down the next point appears equally certain to fall.

In the Newtonian physical world this instinct usually works.

Financial markets, however, do not behave like moving objects. Prices respond to new information that is inherently unpredictable. A chart may display motion, but the motion does not obey the physical rules our brains expect.

The result is a systematic behavioural error. Investors buy assets that have already risen and abandon those that have already fallen.

The tendency to chase recent performance is one of the most persistent findings in behavioural finance.

Investors allocate capital to funds that have recently performed well and withdraw money from those that have underperformed. The behaviour feels rational because it aligns with a deep instinct: the belief that the next point in the series will continue the trajectory of the last.

In practice it often produces the opposite of the intended outcome.

The uncomfortable conclusion is that poor investment outcomes are not primarily a failure of intelligence. They are a consequence of cognitive architecture.

The human brain evolved to detect patterns quickly and to act on them without hesitation. In evolutionary terms the architecture of the brain reflects layers of adaptation: ancient instinctive circuitry concerned with survival sits beneath the slower and more deliberate thinking that arrived later. When confronted with apparent movement, these older, faster responses react first.

Financial markets require the opposite: patience, scepticism and the discipline to ignore patterns that appear compelling.

Successful investing therefore demands something unnatural. It requires resisting instincts that have served humans well for hundreds of thousands of years.

In markets, survival belongs not to those with the fastest instincts, but to those who can override them.



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Supporting Studies

Motion prediction in perception

Experiments show that the visual system automatically extrapolates the future position of moving objects, a phenomenon known as motion extrapolation.

Key study: Nijhawan, R. (1994). Motion extrapolation in catching. *Nature*.

Heuristics and pattern recognition

Behavioural psychology shows humans rely on shortcuts such as the representativeness heuristic, which leads people to assume patterns will continue when judging uncertain outcomes.

Key study: Kahneman, D. & Tversky, A. (1974). Judgment under Uncertainty: Heuristics and Biases. *Science*.

Recency bias in financial expectations

Economic research finds that recent market experience strongly influences expectations of future returns and risk taking.

Key study: Malmendier, U. & Nagel, S. (2011). Depression Babies: Do Macroeconomic Experiences Affect Risk Taking? *NBER*.

Investor behaviour gap

Studies comparing mutual fund performance with investor returns consistently find investors earn lower returns than the investments they hold, largely because of performance chasing and poorly timed buying and selling.

Key study: DALBAR. Quantitative Analysis of Investor Behavior (annual series since 1994).