How is an investor judged? In other words, how can you tell if you are a good investor or a bad investor?

If you are a stock investor, the question is often asked, can you “beat the market”? Can you outperform the SP 500?

The S&P 500 is a measure of the US stock market. So if the market earns 10%, and you earn 15%, you have outperformed the market.

The truth is that most professional investors cannot beat the market.

What type of advantage can you have over professional investors?

So how can the individual investor “beat”, or outperform the market?

Professional investors have access to techonology, information, and capital that the individual investor cannot match.

However, most professionals and individual investors fall victim to certain psychological biases and behaviors that cause them to underperform the market.

Individuals can use psychological edges to outperform the professionals. How? By avoiding certain behaviors.

Loss aversion

As investors, we tend to feel the pain of a loss of $5 more than the happiness of the gain of $5.

So we tend to behave in a way attempts to minimize the pain of loss.

However, this causes us to hold on to losing positions and sell winning positions too early. Why?

Once we have a winning position, we tend to sell after a small gain, because we don’t want to have our winner turn into a loser if the stock goes back down. However, this means that we can never have a big winner in the portfolio that goes up for many years, which reduces our portfolio returns.

If we have a losing position, we don’t want to sell it and take the loss; we would rather wait for the loser to turn into a winner. We want to avoid the pain of loss , so we don’t take the small loss.

This leads to a scenario where the investor keeps holding on to a losing position waiting, often in vain, for the stock to go back to the original purchase price. Of course it may never come back!

So if we sell our winners too early, and hold on to losers too long, we end up with a portfolio of underperforming stocks. This is a key driver for investor underperformance.

Self-attribution bias

Suppose that you invest your money and earn a great return in your first year. Even though this is a very small sample size, you might think that this one year of success is due to your incredible skill as an investor. Psychologically, this fills you with confidence, and you tend to trade more and take greater risk since you attribute your recent success to your impressive skill. Taking excessive risk and overtrading reduces your overall portfolio of returns.

Extrapolation bias

This bias leads investors to think that the way it is today (in the economy or a particular business) is the way it will always be for the foreseeable future. This manner of thinking leads to a narrow view of the world, rather than considering different possible states of the world.

Overconfidence

As I have discussed earlier, overconfidence causes an investor to overestimate his or her skill. This results in excessive trading, which research has shown leads to underperformance, and an increase in risk-taking.

House-money effect

This is an old gambling term. If you walk into a casino with $100, and win $50 dollars playing blackjack, you now have $150. Many gamblers now treat the $50 as “house money”, and feel like they can take greater risk with this $50, since it’s not really “their” money.

Why is this flawed thinking? Because it’s all your money! Money needs to be treated the same, no matter where you get it, and you need to consider risk and return with your entire portfolio.

Snake-bitten investors

The expression “snake-bitten” means that you have done something and had such a terrible experience that you have sworn to never repeat the event again! For example, if you bought a technology stock and lost 90% of your money, you now say, “I am never buying another tech stock again!”.

This is a mistake since you ignore future opportunities that may exist in tech stocks. It means that you don’t have an open mind for future investment ideas.

It pays to be a contrarian

Warren Buffet, a legendary Wall Street investor, has said “be fearful when others are greedy; be greedy when others are fearful”. This is contrarian behavior; another way to think about this is “don’t follow the crowd”. The lesson here is to never to fear going against popular opinion, although it is very difficult.