Investor Biases – Pattern Seeking

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WE ARE CONSTANTLY making decisions – whether it is deciding what's for breakfast, which route to drive to work or where to go for a holiday.

It is well documented that human brains are wired to seek patterns when faced with a lot of information where there is great uncertainty around the outcome.

This tendency to seek 'some kind of pattern' that allows us to "predict" an outcome often sees us make the same mistake over and over again as we come to the same conclusion.

Milad Fakurian/unsplash

The "Coin Toss" Case Study

When asked the most likely outcome of 6 consecutive tosses of a fair coin amongst the below choices:

A. HTHTHT
B. HHTTTH
C. HTTHHT

80% of the respondents to a test chose A, this is because there is a pattern although the correct answer is that all the options are equally likely, when you toss a fair coin 6 consecutive times, Heads (H) or Tails (T) have a 50% probability each. But our brain works to find a pattern and the prediction is then based on this.

Pattern Seeking and Investing

In Psychology, Pattern Seeking refers to the process where our brains try and match a new piece of information with patterns or information already stored in it.

This bias when applied to finance and investing means, we try and look to see how certain events unfolded in the past and superimpose the pattern to a current occurrence.

The fallacy of this, I am sure, is not lost on anyone.

There are constantly new emerging factors and dynamics that impact the market performance and returns.

After all, there is no past template to apply to the emergence of a pandemic like COVID and what it would do to the markets and our everyday living!

It does not always need to be significant events, even in every day, one must be wary of falling into this trap.

This is often referred to as the "Gambler's Fallacy": A situation where you incorrectly measure the probability of an outcome.

For example, consider you bought into a stock that is not doing well.

You continue to hold on to it, under the assumption that it will go up one day and that statistically it cannot go down every day. However, it is a very real possibility that a stock could go down (a 50% chance) each day and even disappear!

So remember, if you see a pattern emerging particularly in the short-term data, it is probably meaningless!
