What part do behavioural biases play in quality investing?

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Quality investing means buying and holding a portfolio of quality companies. IThe behavioural biases of the ‘average’ investor can drive performance patterns that create opportunities for more rational and astute market participants

Six of these behavioural biases may influence how quality stocks perform – we list them below.

Overconfidence bias I: investors

Investors might have too much confidence in their own skills. They may be prone to believe that their expertise will be best rewarded by selecting riskier stocks. Among these could be companies with seemingly greater earnings upside potential. Such potential could be accompanied by higher leverage and more variable earnings, however. This might leave higher-quality, more stable companies undervalued, thereby offering higher returns.

Overconfidence bias II: companies

Company management teams are also prone to overconfidence. They may, for instance, overestimate future growth, guiding the market or even booking profits too bullishly – and investors may fall for these projections. When the actual earnings fail to match expectations, the stock price may fall.

Lottery bias

When it comes to lotteries, people have a tendency to focus on the size of the reward. The larger the jackpot, the more we are willing to ignore the high chance of losing. This gambling behaviour may lead investors to over-pay for stocks with lottery-like payoffs: typically lower-quality stocks that may ultimately disappoint.

> “Human beings have a tendency to favour near-term rewards.”

Present bias

Human beings have a tendency to favour near-term rewards. Present bias means we are likely to overvalue the potential short-term benefits of low-quality companies because they have the possibility of a higher near-term payoff. This means we might undervalue the long-term benefits of quality companies.

Incentives

As always, incentives matter. Some professional investors are incentivised to generate strong short-term performance. They may hope to raise a large amount of assets – or perhaps rescue their career. Others profit from performance fees based on one- or three-year returns. These investors may overpay for volatile stocks with the potential for the highest near-term payoffs.

Managing biases

To prevent our biases adversely affecting the decisions we make, we must understand them. We cannot remove them, but we can build more systematic processes to overcome their negative influences. With this understanding comes the potential to profit from the biases of others.

By adopting a systematic approach to quality, investors can take the other side of the trade to those succumbing to these biases. Investors in quality companies focus on long-term potential, not near-term rewards, and on predictable earnings, not volatile share prices. In this way, a quality approach has the potential to profit from the irrational behaviour of the average investor.
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