Ian Bright: Beware of what you know

'Investing in what you know' is popular investment advice, but sometimes we succumb to unconscious routines and fall for thinking traps.

You think you know them

When you’re choosing investments, what companies stand out? More than half (57%) of investors prefer big-name, well-known brands when creating their portfolios, a UK-based poll by a prominent financial institution. On the face of it, this choice seems entirely natural. After all, the alternative may be buying shares in companies or ventures you know nothing about.

But how much do you usually really know about the bigger names? Perhaps we only think we know them because they are so high profile. Many good companies may not be well known. And familiarity with something isn’t the same as actually understanding it.

The familiarity bias trap

The tendency to go for a household name, in fact, might be little more than familiarity bias. This and other natural human habits of thought can mean missing out on potentially greater returns that may result from a different choice. For example, the Investec survey notes that investors are inclined to buy shares in banks. But how many truly understand how a bank is run?

Lack of diversification can be risky, arguably even imprudent

Aspects of overconfidence could be occurring here as well. Forty-seven percent of respondents said they wouldn't even sell their stake if the shares performed poorly.

The disposition effect bias

They may be falling prey to the disposition effect, where people like to sell the winners but hold on to their losers. A reason may be natural reluctance to admit a mistake and take on board an actual financial loss. When a financial loss only seems to exist on paper, it can be easier to deal with.

The survey also finds that 31% - nearly a third – of investors keep holding shares that they originally bought as new listings on the market, and 21% hang onto shares they inherited from someone else.

Some aspects of mental accounting seem to be at work as well. If 11% of investors admit they hold shares because of the perks they can receive, they seem to be dividing the share price from the perk – considering them as separate "buckets" of value.

The home bias

Yet there are problems with buying only what you know purely from a finance perspective. Concentrating only on what you think you understand may mean your portfolio is insufficiently diverse – a risky strategy in itself. First, if investing only in one country, the tendency may be to unintentionally invest further away from a general market index (such as the UK's FTSE).

Second, there may be unintended consequences from investing in your home country and not being open to opportunities in other countries. This is the "home bias" problem.

A lack of diversification can cause real problems if you tend to invest in what you understand but that tends to be the industry you work in as well. You end up with a double risk. If the industry you work in has a downturn and your income falls a lot (or you lose your job) the shares you own are likely to lose value at the same time.

If I remember correctly, this was a particular problem in the collapse of US energy giant Enron in 2001-2002, once a Wall Street darling. Many Enron staffers had much of their pension savings in Enron shares. Not only did they lose their jobs but they lost part of their pension pot.

It all depends on why you're investing

Having said all that, the whole idea of "invest in what you know" is not necessarily a bad idea. It depends on why you are investing. If you consider saving for your pension as investing, then "invest in what you know" is dangerous.

If you are trying to build long-term wealth for some other reason, the lack of diversification can be risky, arguably even imprudent (if you are, for example, a fund trustee). However, if investing is being done for fun, to dabble in the share market, perhaps, then have a good time! You might get a kick out of getting a dividend payment from that company you have admired for many years.

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