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How Availability Bias and FOMO Can Impact Financial Decision-Making

ACADEMIC PERSPECTIVE

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The increasingly high volume of trading activity by small investors has fueled skyrocketing markets in recent months. Individual investors now account for almost a fifth of shares traded on the stock market.[1] Why is this happening, and why should we care?

Platforms have simplified the trading process and many brokerage firms have slashed their trading commissions to zero, making it much easier and cheaper for novices to invest. But that's only part of the story. To get a more complete picture of why so many individual investors are throwing their hard-earned money into the market, we need to understand the psychological reasons underpinning investor behavior during these uncertain times.

What Do Sharks, Cows and College Have in Common?

If you were to consider which animal is more deadly—sharks or cows—you'd probably say sharks. They *seem* deadly, and there's probably a scary tune you hear in your head when you imagine their fins popping out of the water. They even have a whole week of TV programming dedicated to them!

It turns out, however, that seemingly docile cows kill some 20 Americans per year, on average, while sharks kill just one.[2] The reason we're so likely to think sharks are the deadlier animal has to do with the way we typically make predictions about the world.

When it comes to thinking about what's likely to occur in the future, we think about what was likely to occur in the past and project that ahead in time. We draw on whatever is easiest to conjure. Deaths caused by sharks are easier to imagine and remember because those images are more available in our minds than images of deaths caused by cows.

Think about how this tendency, known as the *availability bias*, could impact investors when the market is particularly strong. It may be the case that if the most easily available performance in recent memory is positive, we tend to overweight the probability that such trends will continue.

Now, switch gears and think about what it's like to be a brand-new student in college with lots of decisions to make—the two classes I need meet at the same time… which one should I take? Should I go out to a party tonight or out with that finance major I met last weekend?

There's no world in which you can make two choices simultaneously, as opting for one path necessitates closing the door on another. It can be painful to realize that doing one thing means you can't do something else. This experience of fear of missing out (FOMO) isn't just a feeling. It can create a strong desire to abandon the status quo and jump into whatever everyone else is doing.

FOMO Can Lead to Herd Behavior

In one of the few research studies on FOMO and consumer behavior, museum-goers informed of other events happening around town were willing to accept a lower dollar amount to leave the museum compared to those who didn't know about concurrent events.[3] FOMO, in other words, ended up being costly.

Moving beyond college students and museumgoers, is it possible that when investors discover how many other investors are getting into the market, or targeting specific stocks or sectors, they think they should do so as well? After all, what might they miss if they don't invest?

Combining the effects of the availability bias and FOMO, we can see how problems might emerge. Although an oversimplified example, consider a group of investors who think tech stocks will continue to surge because they have been surging in the recent past. These investors fear missing out on the potential future gains they so easily imagine, and many other people appear to be earning. If this FOMO spreads quickly, it can cause herd behavior, continuing to drive up prices of those same stocks and sectors.

Meanwhile, another camp of investors has a different goal in mind. This group contemplates entering short positions, believing the market has overvalued certain stocks beyond any reasonable estimates of those companies' fundamentals. These investors could also be succumbing to an availability bias, as it may be easy for them to recall recent times when market bubbles formed and then burst. However, we know maintaining a short position for any extended period in a rising market can be challenging and expensive. In both cases, believing there's a "sure thing" or guaranteed big gains in a short time frame remains a dangerous proposition.

The Bottom Line

As tempted as I am to provide a list of "10 things you can do to get over FOMO and availability bias," there's no panacea. But knowing about both phenomena can help investors modify their decisions to help avoid potentially costly errors.

Whether it's buying the most popular tech stock or shorting it, you might ask why am I making this choice? Is it because it just seems like it'll continue to go up forever? Is it because I'm afraid of missing out on what others are doing, be it investing or shorting? More than anything, asking such questions, having awareness of these biases and consulting with experts may help pump the brakes to allow reflection of how these actions align—or perhaps don't align—with broader financial goals and plans before making decisions.

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ENDNOTES

[1] Alexander Osipovich, "Individual-Investor Boom Reshapes U.S. Stock Market," *The Wall Street Journal*, August 31, 2020. https://www.wsj.com/articles/individual-investor-boom-reshapes-u-s-stock-market-11598866200.

[2] Rawley Z. Heimer, Kristian Ove R. Myrseth and Raphael S. Schoenle, "YOLO: Mortality Beliefs and Household Finance Puzzles," *The Journal of Finance* 74, no.6 (December 2019): 2957-2996. https://doi.org/10.1111/jofi.12828.

[3] Ceren Hayran, Lalin Anik and Zeynep Gürhan-Canli, "Exploring the Antecedents and Consumer Behavioral Consequences of 'Feeling of Missing Out' (Fomo)," *Advances in Consumer Research* 44 (2016): 468. https://www.acrwebsite.org/volumes/1021535/volumes/v44/NA-44.

GLOSSARY

Fundamentals. Fundamentals are typically factors used to determine value that are more economic (growth, interest rates, inflation, employment) and/or financial (income, expenses, assets, credit quality) in nature. In contrast, "technical" factors are based more on market price (into which fundamental factors have been "priced in"), trend and volume factors (supply and demand), and momentum. Technical factors can often override fundamentals in near-term investor and market behavior, but investments with strong fundamental supports should theoretically maintain their value and perform relatively well over long periods.

Long position. This term refers to what most people consider "normal" ownership of an asset or investment, giving the owner the right to transfer ownership, right to any income generated by the asset and right to profits or losses due to any changes in value. Investors generally take long positions assuming the value of what they own will rise and/or generate a significant amount of income.

Short position. Selling short is the sale of a security or futures contract not owned by the seller (the seller borrows it for delivery at the time of the short sale). A profit results if the seller can buy the security or contract later (to return the borrowed security/futures contract) at a lower price. If the price rises, the borrower/seller suffers a loss. It's a technique used to take advantage of anticipated price declines or protect a profit in a long position.