



KEEP CALM AND STAY RATIONAL – BEST STYLES X BEHAVIOURAL FINANCE | APRIL 2025

Emotional and socially-influenced biases and how to avoid them

It has long been known that humans can make decisions in two ways, a rational, thoughtful way, and an instinctive, rash way. Goethe's Faust called it the "two souls" that dwelt in his heart. More recently, the behavioural economist Daniel Kahneman called it the "two systems of thought" in his book *Thinking, Fast and Slow*. In lay parlance, people often speak about the two angels sitting on their shoulders and whispering into their ears, a cautious, "rational angel", and a bold, "instinctive angel".

At the dawn of human history, both angels served their purpose and helped us survive and thrive. The instinctive angel allowed our ancestors to flee from lions, saber-toothed tigers and other predators – similar to how antelopes start to run in a split second once their herd is startled. The rational angel, on the other hand, helped humans band together to hunt mammoths or plan out the sequence of agriculture work needed in order to harvest crops.

Today's humans still rely on both of their angels to make decisions. But with jaguars and bears markedly

rare in our modern, tame cities, the instinctive angel is influencing our decision-making in fields beyond its original purpose. For investors in particular, an often unconscious reliance on our instinctive angel, and the biases associated with this, can lead to suboptimal results.

In this paper, we will look at the emotional and socially influenced biases we act upon in our daily lives, how they influence our investments, and how our Systematic Equity deals with these biases in our Best Styles strategies.

Chocolate and tulips – our instinctive angel follows the herd

In 2024, a new craze sweeps through German supermarkets. The product at the centre of this attention is rationed and stored behind the cashier, alongside other coveted items such as cigarettes or pricy liquors. Consumers are limited to purchasing only a limited amount of items. Copy-cats soon appear, trying to cash in on the hype. Videos emerge on how to concoct that desired specialty at home.

The product in question was Dubai chocolate, a chocolate bar containing a filling of pistachio cream and kunafa, a crispy Middle Eastern dessert specialty. Promoted by influencers on social media, it soon went viral, and consumers flocked to their supermarkets to acquire and try it. At the time of writing, a bar of Dubai chocolate still trades for 5.99 EUR (per 100 g), while standard milk chocolate can be purchased for as little as 1.49 EUR (per 100 g).



The consumers trying out this specialty chocolate are driven by

herd behaviour. Their instinctive angel tells them that they might miss out on the cool new thing, a feeling known as **FOMO (fear of missing out)**. Many companies actively play with their customers' FOMO, offering "limited editions", time-capped discounts or, in the case of premium restaurants and luxury handbags, waiting lists.



When our instinctive angel takes care of investing, it's also prone to fall into herd behaviour. A famous case is the tulip mania in the 17th century Netherlands. Tulips, now synonymous with Holland, had then only recently been introduced to the Low Countries and became very fashionable. Wealthy Dutchmen saw an investment opportunity in investing into rare tulip bulbs, hoping they would be able to sell them onwards at a higher price. At the peak of tulip mania, in early 1637, a single tulip bulb could cost as much as ten times the annual salary of a skilled artisan. The market collapsed in February 1637.

Many other investment bubbles have followed since. The stock market bubble during the "Roaring Twenties" culminated in the crash of 1929. At the peak of the Japanese

asset price bubble (1989), the grounds of the Imperial Palace in Tokyo were estimated to be worth more than the whole state of California. In the 1990s, the emergence of the internet fueled the dotcom bubble. But herding behaviour also happens at smaller scales. So-called "meme stocks" such as GameStop have risen due to hype on social media, as have certain cryptocurrencies. Our instinctive angel – and its herding bias – is thus seldom a good counsellor for long-term investing.

Toilet paper and casinos – the moods of our instinctive angel

Supermarkets again – this time in the spring of 2020. As the covid pandemic spreads, and lockdowns are declared, an irrational fear of being stuck at home without essential products grips consumers.



Supermarkets are swarmed by panicked consumers who start to hoard such essentials – most iconically toilet paper. Despite reassurances from the paper industry that no shortage is at hand, consumers pile it up in astonishing amounts.

Here our instinctive angel was at work again. Mood is a strong influence on our behaviour, in particular **fear and greed**. Fear can lead us to buy items at outlandish prices, or sell them at a loss. Greed leads us to overestimate probabilities of success, a fact casinos and lotteries capitalize upon.



When investing, our greedy instinctive angel will lead us to invest in overpriced stocks – especially those touted by the media (classic and new) as top performers. The Finnish phone company Nokia, for instance, was a popular stock for many years, representing as much as a 70% of the Finnish stock market at its peak in 2000, despite the underlying problems of its core business. Fear can lead us astray in the opposite direction: minor negative news and small dips in stock prices can snowball into a broad market sell-off as panic spreads, despite there being no general problem in the economy. This happened on Black Monday (19. October 1987), for instance, when the S&P 500 fell over 20% in a single day, after several days of weak performance. Despite fears of a new depression, markets rallied soon after, as the economy proved to be fundamentally sound.

Remaining objective and stoic – how Best Styles harnesses our rational brain to invest

Best Styles is a disciplined approach to investing which avoids listening to the “emotional angel”. It relies on rational insights, through academic research, on the structure of equity markets and how this can be exploited to generate higher returns. It is much closer to how our rational brain works.

A systematic equity approach such as Best Styles, relying on data and quantitative processes, in itself cannot be biased by human emotions or social influence as it follows pre-defined rules based on statistical analysis of historical data.

Obviously, computers do not know fear or greed. Nor does its proper functioning depend on moods, optimism, or regret. A systematic approach measures and controls risks continuously and consistently while taking opportunities into account. Unlike some human investors, they do not panic during market downturns or become greedy in bull markets. Stocks will only be bought if they meet certain pre-defined criteria and sold when they no longer do. This helps to avoid overexposure in euphoric markets and prevents panic selling during downturns.

And of course, computers don't buy chocolate or tulips. But investors in financial markets are equally prone to herding behaviour (“following the crowd”) which can drive stock prices up – until they fall down to earth again. A systematic investment approach can help to avoid some of these pitfalls as it always takes a wide range of data sources into account to evaluate each stock.

It processes the information, mainly based on hard facts and numbers such as reported earnings or measures based on balance sheet items, objectively and in a disciplined way. It allocates capital based on evidence, not popularity, reducing the risk of chasing a fad.

Systematic equity investors do include some information that reflects market moves, e.g. price appreciation or depreciation, or market sentiment such as earning upgrades or downgrades by analysts. But again, this information is evaluated systematically and in a disciplined way.

And we know, machines can also lead to biases. These can be driven by the underlying data that is used, which itself might be produced by humans or human behaviour, or through the quantitative methods employed such as artificial intelligence.

A systematic approach in itself is not a panacea. When, in 2007, many human investors used the same systematic methods to select stocks this also led to herding – and a subsequent crash. Best Styles is well aware of this and explicitly manages exposure to this type of market behaviour by controlling the amount of investment style overlaps, as this can also be considered a form of herding.

By relying on data, clear rules and disciplines execution, a systematic equity strategy is an investment strategy more like our rational brain. This helps to mitigate emotional or social influences. It ensures that investment decisions are guided by logic, ultimately leading to more consistent and robust long-term performance.

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