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Recognition Heuristic Bias and Cognitive Heuristic In Investment Activities

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ABSTRACT
This study aims to examine in more depth the impacts caused by behavioral bias driven by recognition heuristics and cognitive heuristics in investment activities. This research method uses qualitative with phenomenology of data collection using participant observation and interviews with investors who join the domestic investment community. The results of this study indicate that investor perceptions of heuristic bias in investment activities consist of mental shortcuts and practical mindsets. The second finding is the type of heuristic bias in investment activities such as recognition heuristic bias and cognitive heuristics. The last finding in this study is the impact of recognition heuristic bias and cognitive heuristics in investment activities including suboptimal portfolio performance diversification and major losses on investments owned due to the use of heuristics. The implications of this study as a source of insight for investors to pay more attention to market information and financial readiness in order to avoid detrimental investment decisions and provide the expected benefits in the future. For the Financial Services Authority (OJK), it can be a guideline so that it can provide socialization to the public, especially for novice investors, regarding knowledge, benefits and how to invest properly and correctly to increase the interest and quality of knowledge of novice investors regarding investment.

Keywords: *Recognition Heuristic Bias, Cognitive Heuristic Bias, Investors, Investment Activities*

1. INTRODUCTION

Investor behavior plays an important role in investment decision making, especially in financial markets (Shah et al., 2018). In the Indonesian stock market, investors often behave irrationally due to psychological factors, which cause bias in investment decisions (Kasoga, 2021). Rational investors will make choices based on available information and reasonable profit expectations (Raut, 2020), while irrational behavior is more often caused by emotional factors and less than optimal habits (Zahera & Bansal, 2018). These psychological factors often lead to decision errors that can be detrimental to investment ((Heymans, 2022). Irrational investors tend to make unprofitable decisions, while rational investors will choose investments whose returns are expected to cover all costs (Mccarthy, 2020). In uncertain market conditions, decision making becomes very complex and is influenced by limitations in information, time, and cognitive abilities (Simon, 1955)

The use of heuristics to overcome these limitations can speed up decision making (Tversky & Kahneman, 1973), but often causes biases that lead to systematic errors in investment decisions ((Tversky & Kahneman, 1974). Investment success is highly dependent on the quality of decision making and the right time to take advantage of opportunities (Weixiang et al., 2022). Biases in decision making, including heuristic biases, often occur in individual investors who are more prone to judgment errors compared to institutional investors (Zahera & Bansal, 2018). These biases, such as disposition bias and overconfidence, can be detrimental to investment decisions (Hidayat et al., 2023). Heuristic biases can also lead to market anomalies that continue to develop and reduce investment performance ((Mccarthy, 2020). Previous studies have also shown that the use of heuristics in decision making often has a negative impact on the efficiency of investment decisions (Ahmad et al., 2023).

This study aims to examine in more depth the impact of behavioral bias caused by recognition and cognitive heuristics in investment. This study also fills the methodological gaps in previous studies, using a qualitative approach to gain a deeper contextual understanding. Therefore, researchers focus more on the impact of using recognition heuristics and cognitive heuristics in investment activities. Thus, this study is expected to provide a theoretical impact on behavioral finance theory, especially regarding the impact of recognition and cognitive heuristics in investment in order to contribute to the world of education. Practically, this study is expected to provide insight for investors in overcoming the negative impact of heuristic bias and avoiding fatal errors in investment decisions. This study is also expected to provide input for capital market regulations, so that the financial services authority (OJK) can develop policies that protect investors from detrimental heuristic bias.

1.1 Prospect Theory

Tversky & Kahneman, (2019) state that individuals make decisions based on the gains and losses obtained, not the optimal end result. This theory is related to heuristics, where individuals tend to use mental shortcuts to simplify the evaluation of uncertain probabilities (Tversky & Kahneman, 1974). This theory combines aspects of economics and psychology, explaining human behavior that is often contradictory and irrational (Tversky & Kahneman, 2019). In making investment decisions, this theory shows that investors tend to take risks in the face of losses, holding losing stocks because they avoid the pain of further losses rather than gaining profits (Shefrin & Statman, 1984). This prospect theory is reflected in the S curve that describes individual reactions to losses and gains. Individuals tend to avoid risk in profit situations, but seek risk when experiencing losses, in the hope of reducing these losses (Tversky & Kahneman, 2019). Fear of loss often influences the decisions made, causing investors to use heuristics that can worsen decisions and result in suboptimal investment performance (Raab et al., 2019).

1.2 Heuristic Driven Behavioral Biases

Heuristics are practical approaches to making quick and efficient decisions, although they do not always result in optimal decisions. In the context of investment, heuristics such as the recognition heuristic and cognitive heuristic often influence investor decisions. The recognition heuristic, for example, shows that individuals tend to choose something that is already familiar, even though there is stronger evidence supporting other options. In investment, this is seen when investors choose to invest in large, well-known companies rather than smaller, more profitable companies (Raue & Scholl, 2018). This can lead to irrational and suboptimal decisions, as investors rely more on familiarity than in-depth analysis (Mousavi & Gigerenzer, 2017). In addition, cognitive heuristics also influence investment decisions. Cognitive biases such as groupthink, disposition effect, and anchoring bias can lead to irrational decisions. For example, the disposition effect describes the tendency of investors to sell winning stocks too quickly and hold losing stocks too long, which is often caused by psychological factors (Oreng et al., 2021). Other biases, such as the recency effect and overconfidence bias, can cause investors to be more influenced by recent information or feel overconfident in their decisions, which risks ignoring deeper analysis (Shah & Butt, 2024).

1.3 Impact of Recognition Heuristic Biases and Cognitive Heuristics in Investment Activities

In investment management, recognition and cognitive heuristics can lead to a lack of portfolio diversification and risky decision-making, such as relying too much on familiar stocks or being overconfident in choosing certain stocks (Gavrilakis & Floros, 2022). This can have a negative impact on long-term investment performance, as the decisions taken may be suboptimal and influenced by existing biases (Gigerenzer & Goldstein, 2011). Another impact of using heuristics can lead to a lack of diversification so that investors who are influenced by recognition heuristics may only invest in stocks or products that they are familiar with, without considering better or more profitable alternatives (Mikołajek, 2017). In addition, the increased risk experienced when using heuristics, investors also tend to experience overconfidence bias or availability bias, which can cause investors to take unnecessary or excessive risks (Kirera & Mburugu, 2019). Therefore, it is important for investors to recognize and reduce the influence of heuristics in decision making, by utilizing more rational and data-based analysis (Huseynov et al., 2020).

2. RESEARCH METHODS

This study uses a qualitative method to examine the impact of behavioral bias due to recognition heuristics and cognitive heuristics in investment. This method involves searching for meaning through symptoms, symbols, verbal communication, and written texts in a narrative manner to understand the phenomenon in depth (Cassell et al., 2017). The phenomenological approach was chosen to investigate the experiences experienced by individuals or groups (Nasir et al., 2023). This study examines the impact of heuristic bias experienced by investors in decision making. This study involved investors with direct experience in the investment world, both stocks and mutual funds, resulting in diverse perspectives based on their respective experiences (Creswell & Poth, 2016). The subjects of this study were individual investors who were members of the domestic investor community. Individual investors were chosen because they more often experience bias in investment decisions due to the influence of overconfidence (Alifya et al., 2024). This study uses purposive sampling techniques to select relevant informants with certain criteria, such as having at least one year of investment experience and being willing to be interviewed. The snowball sampling technique is used to expand the participant network based on recommendations (Sugiyono, 2017). This study also uses triangulation techniques in data collection through observation, semi-structured interviews, and documentation (Rofiah, 2022). Observation involves researchers in the investment community to understand psychological factors that can cause bias. Semi-structured interviews develop according to research needs, and documentation is used to support data validity. Data analysis was carried out using thematic analysis to identify patterns or themes in qualitative data (Braun & Clarke, 2006). The analysis process includes six phases, namely recognizing data, creating initial codes, searching for themes, reviewing themes, establishing themes, and finally compiling an in-depth report with relevant examples.

3. RESULT AND DISCUSSION

The results of this study were obtained from data compiled by researchers based on coding. The data collection process has been carried out through observation and interview processes. Observations were made in the domestic investor community when making decisions in choosing an investment, overcoming losses and profits, and how to handle the impacts caused by the chosen investment. Interviews were conducted with thirteen informants consisting of nine male investors and four female investors. Based on the results of the coding, this study emerged four themes, namely investor perceptions of heuristic bias, types of heuristic bias in investment, the impact of recognition heuristic bias and cognitive heuristics in investment activities, and strategies for overcoming heuristic bias in investment activities.

3.1 Investor Perceptions of Heuristic Bias

The theme of investor perception of heuristic bias is a theme that emerged from the results of data analysis, this theme explains how investors view heuristic bias. Informants in this study revealed investor perceptions of heuristic bias, namely mental shortcuts or practical thinking patterns. Heuristic bias is a human tendency to make decisions or draw conclusions based on existing rules of thumb or patterns, often without in-depth analysis, usually done when someone is faced with uncertain and time-limited choices (Tversky & Kahneman, 1974). This bias arises from the use of heuristics, namely fast and simple thinking strategies that can be very helpful in situations that require quick decisions. Although efficient, heuristics are not always accurate and often lead to errors in judgment (Handoko et al., 2024). For example, in the context of investment, investors who use the recognition heuristic may assume that the shares of a company they know and are more familiar with are able to provide profits because they feel safer and have invested in shares before, even though market conditions and the company's fundamentals may change. This statement supports the prospect theory which states that a person does not always act rationally when faced with risk and uncertainty. The results of this study are in line with Rozak et al., (2023) who stated that when heuristics are not applied properly and in accordance with relevant data, it will result in bias in decision making.

3.2 Types of Heuristic Bias in Investment Activities

The theme of heuristic bias in investment activities emerged from the data analysis, the researchers highlighted the types of heuristic biases that investors face during decision making. The study identified two main types, namely recognition heuristic bias and cognitive heuristic bias. Recognition heuristic bias refers to the tendency to choose a familiar option over an unfamiliar one, even if other alternatives are supported by stronger evidence (Raue & Scholl, 2018). Informants revealed that this bias often occurs because investors feel more confident in familiar investments, even if there are better options. Recognition heuristics help in quick decision making, where in-depth analysis is not possible (Gadzinski et al., 2022). However, this shortcut can lead to irrational choices, especially when familiarity does not reflect true value. This concept is in line with prospect theory, which states that people act irrationally when faced with uncertain outcomes, influenced by how choices are framed as potential gains or losses. Jain et al., (2019) also stated that sticking to familiar stocks can cause investors to miss out on more profitable opportunities. Cognitive heuristic bias involves using mental shortcuts to make quick decisions (Cascão et al., 2023). Investors tend to avoid conflict and follow the majority, even when it is not the best option. This behavior is consistent with prospect theory, which explains how cognitive biases lead to irrational decisions, especially when individuals use simple rules that distort judgment. Ahmad & Wu, (2023) highlight how cognitive biases such as groupthink, where individuals prioritize group harmony over rationality, can significantly impact investment decisions.

3.3 The Impact of Recognition Heuristic Bias and Cognitive Heuristics in Investment Activities

The theme of the impact of recognition heuristic bias and cognitive heuristics in investment activities is a theme that emerged from the results of data analysis, the theme explains what impacts are caused by the use of recognition heuristics and cognitive heuristics when making decisions in investment activities. Informants in this study revealed that there are three impacts of recognition heuristic bias and cognitive heuristics experienced by investors in investment activities, namely, investor portfolio performance, irrational decisions, and investment losses. Recognition heuristic bias often occurs when investors prefer assets or investments that they are familiar with, even though there are other choices that are more rationally profitable. Informants in this study explained that investors sometimes prefer stocks from large and well-known companies simply because they are more familiar with the brand, even if other companies with higher risk profiles and higher potential returns may be more suitable for their investment goals. In line with prospect theory, the results of this study support that decision making by investors is often irrational due to the use of recognition heuristics, so that it will have an impact on the diversification of less than optimal portfolio performance. This is supported by research Ar-Rachman, (2018) who stated that poor diversification can increase overall portfolio risk and reduce long-term performance.

This can result in reduced profits due to only focusing on familiar assets, investors may miss out on more profitable or growing investment opportunities, which can hinder the potential for portfolio growth. Informants in this study revealed that cognitive heuristic biases such as anchoring bias can cause investors to persist in bad investments or fail to identify warning signs before major losses occur. This bias prevents them from making rational decisions about when to sell or transfer their funds to more profitable investments. This is in line with prospect theory which states that investment decisions are often not entirely rational and are influenced by various psychological factors, including how information is presented and how easy it is to remember information, as well as how individuals perceive potential losses or gains in their investments. Budiman, (2023) also stated that the use of cognitive heuristics such as anchoring bias makes it possible for investors to maintain assets that previously had high prices, even though market conditions have changed. This can lead to greater losses as they do not act quickly when prices start to fall, which can result in greater losses from failed investments.

4. CONCLUSION

This study identified three main findings. First, this study highlights investors' perceptions of heuristic biases in investment activities, focusing on mental shortcuts and practical mindsets. Second, this study categorizes the types of heuristic biases encountered in investment decisions, namely recognition heuristic bias and cognitive heuristic bias. Third, this study examines the impact of heuristic biases, revealing that these biases contribute to suboptimal portfolio diversification and significant investment losses. These findings were obtained from interviews with investors in the investment community. The implications of this study are able to provide individual investors with insight to be more aware of recognition heuristic biases and cognitive heuristic biases, as these biases can significantly affect investment choices. Investors are also required to deepen their knowledge of investment strategies in order to help reduce the impact of biases and improve overall investment results. Furthermore, this study emphasizes the importance of staying on top of market trends and ensuring financial readiness to avoid bad investment decisions, which ultimately lead to more profitable results. For the Financial Services Authority (OJK), the results of this study can be a guideline in increasing educational efforts to the public, especially novice investors, regarding investment knowledge, strategies, and practices. Thus, OJK can improve the understanding of novice investors, reduce bias, and encourage more profitable investments, thereby contributing to national economic growth. Finally, this study recommends further research using a mixed-method approach and factor analysis to better measure the prevalence and impact of various biases in investment decisions. This will provide deeper insights into the role of heuristics in shaping investor behavior and improve strategies to improve investment decision making.

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