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Recency Bias and Mutual Fund Investing

Investing is as much about managing emotions as it is about managing money. One of the most common behavioural mistakes made by investors is **recency bias**. Recency bias refers to the tendency to give excessive importance to recent events while ignoring long-term trends and fundamentals. In mutual fund investing, this often leads investors to make decisions based on short-term performance rather than long-term objectives. Recency bias can significantly affect investment outcomes. Investors tend to assume that what has happened recently will continue indefinitely. As a result, they often rush into funds that have delivered exceptional returns in the recent past and avoid those that have underperformed, without considering whether the underlying fundamentals have changed.

Understanding Recency Bias

Suppose a small-cap fund has generated outstanding returns over the last one or two years. Many investors may conclude that the fund will continue to outperform and invest heavily in it. Conversely, if a fund has delivered below-average returns over a short period, investors may redeem their investments believing that the fund is no longer attractive.

However, markets move in cycles. Asset classes, sectors, and investment styles periodically outperform and underperform. Short-term performance often says very little about long-term prospects.

Recency bias causes investors to confuse temporary trends with permanent realities.

How Recency Bias Affects Mutual Fund Investors

1. Chasing Past Performance

Many investors choose funds based solely on recent returns. They often invest in categories that have performed well recently and ignore the fact that valuations may already be elevated.

2. Exiting During Market Corrections

When markets decline, investors influenced by recent negative returns may panic and redeem their investments. Such decisions lock in losses and prevent them from benefiting when markets recover.



3. Ignoring Long-Term Fundamentals

A temporary decline in returns does not necessarily indicate deterioration in the quality of a fund. Changes in market conditions can cause even good funds to underperform for certain periods. Recency bias prevents investors from evaluating the underlying portfolio, fund manager philosophy, and long-term potential.

4. Frequent Portfolio Changes

Investors affected by recency bias often keep switching between funds and categories. Frequent changes increase transaction costs and may disrupt the compounding process that is essential for long-term wealth creation.

Why Past Performance Alone Is Not Enough

Performance measures such as CAGR, alpha, and Sharpe ratio are useful tools, but they should not be viewed in isolation. A fund's underlying portfolio, sector allocation, valuation levels, investment process, and the experience of the fund manager are equally important.

For example, a fund may have experienced short-term underperformance because the sectors it is invested in are temporarily out of favor. If the long-term growth drivers remain intact, the fund may still have significant potential.

Therefore, investors should evaluate both quantitative measures and qualitative factors before making investment decisions.

How to Avoid Recency Bias

Focus on Financial Goals

Investments should be aligned with long-term financial objectives rather than recent market movements. Goal-based investing helps investors remain disciplined during periods of volatility.

Review the Portfolio, Not Just Returns

Understanding where the fund manager has invested and why those sectors are expected to grow can provide better insight than merely observing short-term returns.

Maintain Asset Allocation

A diversified portfolio across equity, debt, and other asset classes reduces the temptation to chase recent winners and helps manage risk effectively.

Stay Invested

Time in the market is often more important than timing the market. Investors who remain disciplined and continue their SIPs during market fluctuations are more likely to benefit from compounding.



Conclusion

Recency bias is one of the biggest enemies of successful investing. It encourages investors to buy high, sell low, and make decisions based on emotions rather than fundamentals. In mutual fund investing, short-term performance should never overshadow long-term objectives, portfolio quality, and disciplined investing.

Successful investors understand that markets are cyclical and that temporary underperformance does not necessarily imply permanent weakness. By avoiding recency bias and focusing on long-term goals, investors can make better decisions and improve their chances of achieving sustainable wealth creation.

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* Mutual funds are subject to market risks. Please read all scheme-related documents carefully before investing. Past performance does not indicate future results. Investments are subject to market fluctuations, and there is no assurance of returns.

