Behavioral Finance:

Understanding how the mind can help or hinder investment success

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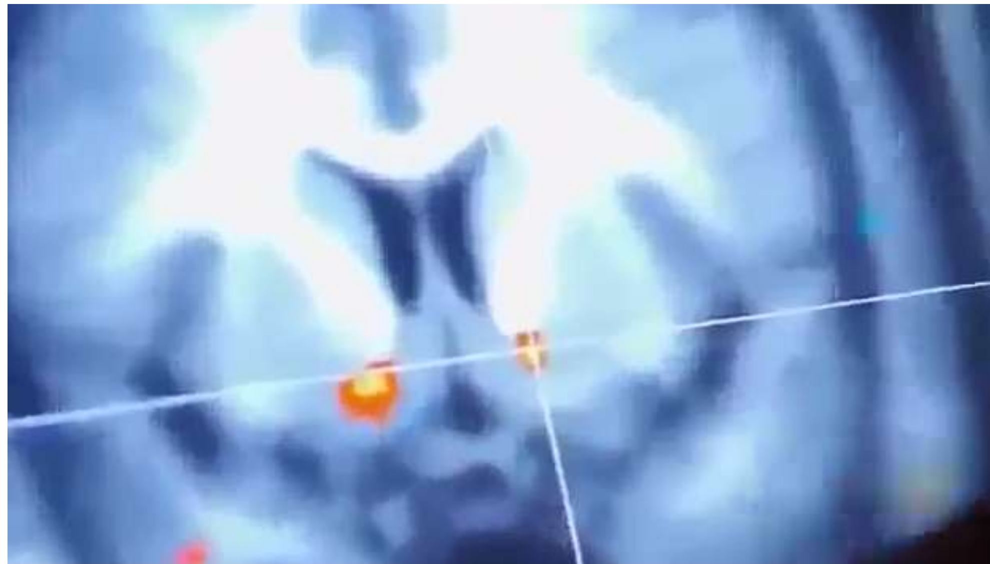
Our Goal?

- Behavioral finance holds out the prospect of a better understanding of financial market behavior and scope for investors to make better investment decisions based on an understanding of the potential pitfalls
- Emotions and sentiment play a crucial role in determining the behavior of investors
- You as financial advisers will learn to understand your own biases and also act as a behavioral coach to your clients to help them deal with their own biases
- The takeaway is to know the pitfalls and to avoid making mistakes when recommending stocks and improving your quality of service

Does raw human emotion dictate your financial decisions?

or are we rational calculators of our own self interest. It is a bitter scientific debate that has real world consequences. The crash of 2008 nearly collapses the global economy. the crash is unexplained by the discipline of economics. A set of amazing experiments reveals it was no surprise. Experiments show our behavior is bizarre when it comes to money. It is almost an irresistible force. What happens when two powerful forces collide? Emotions still drives the markets, Mind over Money



What is Behavioral Finance?

Combines cognitive psychology and finance

Emotions systematically influence our financial behaviors…

… can explain unusual market movements and irrational decisions

We talk about the role greed and fear play in driving stock markets. Behavioral finance extends this analysis to the role of biases in decision making, behavioral finance takes the insights of psychological research and applies them to financial decision making

Traditional vs. behavioral finance

Traditional Finance	Behavioral Finance
Investors are rational	Investors are normal
Rational investors have little difficulty making financial decisions and are well-informed, careful and consistent	Normal investors are not stupid, but neither are totally rational and rarely behave according to the assumptions made in traditional finance theory
Carefully consider all information and not confused by how information is presented	Act based on imperfect information and how information is presented
In aggregate people are not swayed by their emotions	In aggregate people are swayed by their cognitive biases & emotions
Markets are efficient	Markets are inefficient
Quickly incorporate all known information	May be difficult to beat in the long term
Represent the true value of all securities	There are anomalies and excesses in the short term

How markets actually work

"Great investors conceptualize problems differently than other investors. These investors do not succeed by accessing better information; they succeed by using it differently than others."
-Michael Mauboussin

3 Factors That Move Markets:

1. Fundamental Data- Intrinsic (i.e. subjective) value of what something is worth

2. Technical Data- Objective study of price and volume

3. Psychology: Emotions drive markets higher and lower

Most people make emotional decisions

Asian Investors like:

- Fast decisions
- Don’t like to lose face
- “News dominated”
- Not trusting – don’t like advice
- Then too trusting

Makes investors very susceptible to BEHAVIOURAL BIAS

(flaw in the judgement)

Behavioral biases affect investment behavior

- Research in psychology has documented a range of decision-making behaviors called biases
- These biases can affect all types of decision-making, but have particular implications in relation to money and investing
- These biases can affect the decisions we take on particular investments
- Individual investors can fall prey to the biases, but as a part of human nature, advisers are also highly vulnerable
- If we understand them and their effects, we may be able to reduce their influence and learn to work around them

We are all biased

Judicial rulings in favour of parole for prisoners by time of the day

(dotted lines are food or drink breaks)

Proportion favorable decisions

0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0

Ordinal position

Source: Danziger *et al.* Proc Nat Acad Sci (2011)

Common market biases

1. Betrayal Aversion
2. Overconfidence
3. Herd Instinct
4. Confirmation Bias
5. Illusion of Control
6. Optimism
7. Loss Aversion
8. Regret Avoidance
9. Endowment
10. Anchoring
11. Narrow Framing
12. Mental Accounting
13. Availability Bias
14. Fear

- May hinder investment decisions
- Advisers who incorporate behavioral finance insights into their practices will improve the outcomes for their clients by making prudent recommendations in a way that increases the odds that the clients will act upon them
- The adviser–client relationship works best when the ground rules are established at the beginning
- When establishing rules, the adviser will benefit from understanding four tendencies exhibited by most people—tendencies that can potentially influence all interactions between adviser and client. These tendencies are betrayal aversion, overconfidence, the illusion of control, and optimism

Trust me …

Betrayal Aversion

- Individuals who use an adviser are not buying a device or a commodity - They are hiring a person to perform an ongoing service in an area of life that they find deeply personal and that some people even find scary and/or overwhelming
- Individuals entering into such a relationship subject themselves not only to the inherent risk of the financial markets but also to social risk – when you say "Trust me; I'm an experienced professional.", can trigger betrayal aversion

- ***Recommendation: Establish, communicate and document an investment philosophy and a disciplined process that can be easily understood by unsophisticated clients***

Overconfidence

- Humans tend to have unwarranted confidence when making decisions involving uncertain outcomes - having an inflated view of one's own abilities
- Investors or their advisors with misguided conviction may over rely on their stock-picking skills and not diversify
- A key to success in the advisory business is setting realistic expectations and living up to those expectations in clients' eyes

- ***Recommendation: Avoid making overconfident statements to clients***

- ***Recommendation: Communicate realistic odds of success***

Speculative Bubbles

We all have a tendency towards being overconfident in rising markets and unduly loss averse in falling markets

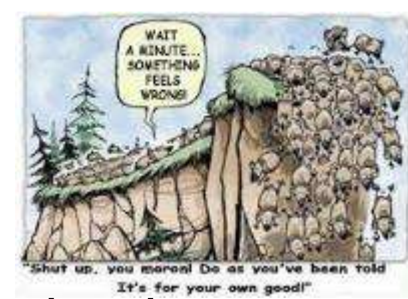
Valuation

"New Paradigm"!!!
Delusion
Denial
Return to "normal"
Greed
Bull trap
Fear
Smart Money
Institutional investors
Public
Enthusiasm
Capitulation
Media attention
First Sell off
Return to the mean
Bear trap
Take off
Despair
Mean

Stealth Phase
Awareness Phase
Mania Phase
Blow off Phase

Time

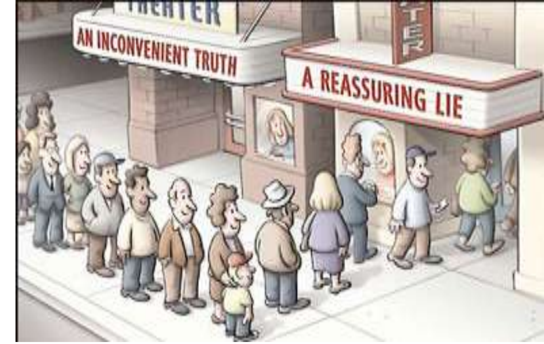
Herd Instinct



- Investments favored by the herd can easily become overvalued because the investment's high values are usually based on optimism and not on the underlying fundamentals
- Bubble is a market situation in which news of price increases spurs investor enthusiasm
- Bubbles are not purely psychological phenomena. They are an epidemic, and an epidemic requires contagion. An epidemic (bubble) can exist only if conditions favor contagion
- The bubble expands by psychological contagion from person to person, and this contagion brings in more and more investors who, despite doubts about fundamental value, find themselves drawn to the investment partly through envy and a gambler’s excitement

- ***Recommendation: do your homework before following any trend***

Confirmation Bias



- Tendency to search for and assimilate data that confirms one’s preconceptions but to overlook evidence that contradicts them
- Confirmation biases contribute to overconfidence in personal beliefs and ignoring contrary evidence that their strategies will lose money

- ***Recommendation: adopt a contrary viewpoint “for the sake of argument” and if there is an investment committee, one could be assigned a formal role as “devil’s advocate” to challenge the propose course of action***

Illusion of Control

- Tendency of individuals to think they have more influence over events than they actually do
- Positive outcome of a decision is viewed as their skill whereas negative outcome is attributed to bad luck
- Clients have an unrealistic perception that advisers have a level of control over outcomes in investing as the advisor is obviously familiar with investments, spends all day, every day doing it, and makes representations that he is a top-notch RIA

- ***Recommendation: Be clear about what you, as the adviser, do and do not control.***

Optimism

- Individuals tend to be optimists, Optimists tend t
  1. overestimate their skills,
  2. suffer from illusion of control, and
  3. underestimate the odds that a bad event will affect them
- Optimism interacts with overconfidence and illusion of control to make a bad situation worse as each of the three reinforces the other

- ***Recommendation: Make clients aware of the downside or risks of your recommendations***

Loss Aversion

Experiments show myopic loss aversion is hardwired to our brain

- Investors are more sensitive to a loss than to a gain of equal magnitude
- Some people weigh losses more than twice as heavily as potential gains i.e. losing Rs.100k hurts more than the pleasure of gaining Rs. 100k
- Investors shows highly risk-averse behavior when facing a profit (selling and locking in a sure gain) and more risk tolerant or risk seeking behavior when facing a loss (continuing to hold the investment hoping price will rise again)
- The tendency to sell winners and hold on to losers harmed investment returns

- ***Recommendation: Help clients to deal with loss aversion and contain their desire to sell winners and hold losing investments by helping clients to evaluate whether the investment still has good future prospects and whether it is still suitable for the client***

Regret Avoidance

- Perfectly reason-able and well-intentioned recommendations go wrong all the time, and each mistake creates regret
- Clients can be resistant in areas with which they have little familiarity or have had had disastrous experience in the past
- Past history of the client will influence how current recommendations are viewed

- ***Recommendation: Make sure you understand the client's past investment experience and get the client "buy in" for each recommendation***

Endowment Effect

- The longer a security is held, the more emotionally attached the investor becomes and the less willing the investor is to part with it, irrespective of the investment merits for doing so
- Length of ownership is positively correlated with the price at which clients are willing to sell
- When we do an intra your clients come with already existing portfolio the client was responsible for creating - where you may find it difficult to convince the client to part with those holdings because of the endowment effect

- ***Recommendation: Understand the ownership history and spend substantial time explaining the rationale for and obtaining client buy-in for a recommended sale of long-held positions***

Anchoring

- Common human tendency to rely too heavily on the first piece of information offered (the "anchor") when making decisions
- Some investors invest in the stocks of companies that have fallen considerably in a very short amount of time. In this case, the investor is anchoring on a recent "high" that the stock has achieved and consequently believes that the drop in price provides an opportunity to buy the stock at a discount
- Values such as market index levels can act as anchors. Round numbers such as 7,500 points on the ASPI, attract disproportionate interest, despite them being numbers like any other
- ***Recommendation: Be careful about which figures you use to evaluate a stock's potential. There is no substitute for rigorous fundamental analysis***

Narrow Framing

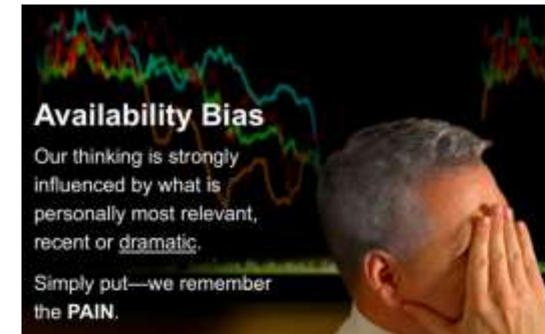
- Occurs when an individual lets his or her judgments be affected by the way a choice is presented, so people do not always judge things in a purely rational way
- Focus overwhelmingly on the behavior of individual securities
- Tend to fuss over the poor performance of a specific security
- Evaluates each trading decision in isolation, without considering the rest of the portfolio
- These 'narrow' frames tend to increase investor sensitivity to loss
- ***Recommendation: bundle recommendations and evaluate performance at the aggregate level, with a 'wide' frame where investors will exhibit a greater tendency to accept short-term losses of individual securities***

Mental Accounting

- Our psychological self thinks about money and risk through 'mental accounts' – separating our wealth into various buckets
- Accounts can also vary in risk tolerance, investing some in risky assets for gain while treating others more conservatively
- This natural tendency to create mental buckets also causes us to focus on the individual buckets rather than thinking broadly

- ***Recommendation: Counsel clients to evaluate their financial assets as a whole in terms of their entire wealth position***

Availability Bias



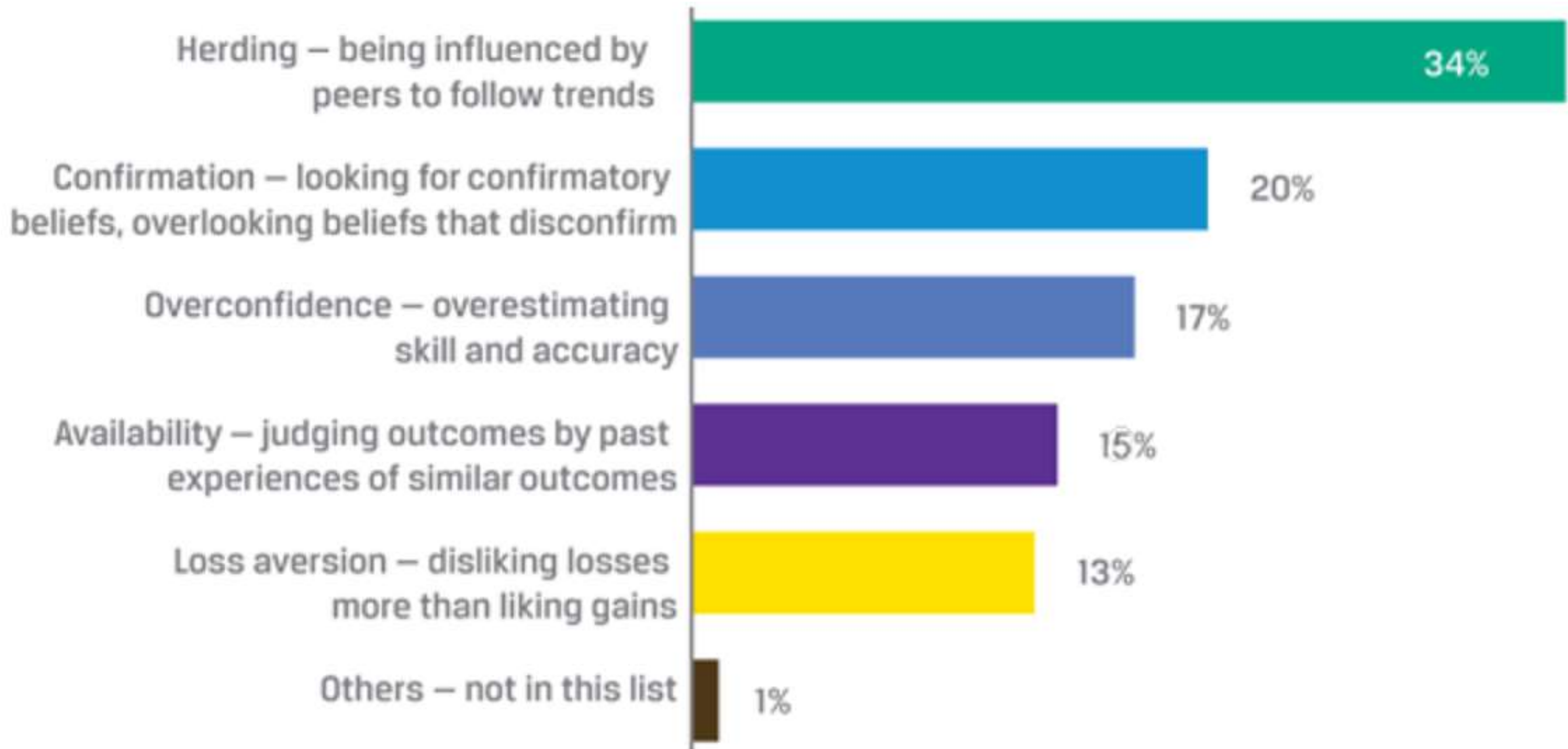
- Recently observed or experienced events strongly influence decisions
- The recent memory made the prospect more vivid – available – and therefore more likely
- Investors are more likely to be fearful of a stock market crash when one has occurred in the recent past

- ***Recommendation: Counsel clients NOT to view investment opportunities through an overly negative lens, due to current market conditions making it less appealing to consider taking on investment risk***

Managing the biases

- Medical imaging technology allows us to look at brain activity as decisions are being made. This helps us to understand the nature and reasons for certain behavioral biases
- Understanding these different biases and the influence they have on investment behavior will help advisors to reduce the adverse impact to your clients
- We cannot cure the biases, but we can attempt to mitigate their effects
- Using techniques such as feedback, audit trails for investment decisions made, checklists, etc. we can avoid the behavioral pitfalls and improve the chances of investment success

Which Biases affects Investment Decision Making the Most?



CFA Institute survey results Aug 2015 across the world

Most people are dominated by Fear

What Are You Afraid Of?

1. Which is riskier: Overexposure to radiation or to sunlight?
2. Which animal is responsible for the greatest number of human deaths in the U.S.?
   a. Alligator
   b. Bear
   c. Deer
   d. Shark
   e. Snake
3. Match the causes of death (on the left) with the number of annual fatalities worldwide (on the right):

a. War	i. 310,000
b. Suicide	ii. 815,000
c. Homicide	iii. 520,000

Fear – Putting it in Context

Answers:

1. 8,000 Americans are killed every year due to overexposure to the sun whereas Chernobyl - the worst nuclear accident in 1986 fewer than 100 had died by 2006
2. Deer are responsible for roughly 130 human fatalities seven times more than alligators, bears, sharks, and snakes combined, deer don't attack with teeth or claw, they step in front of speeding cars, causing deadly collisions
3. Causes of death with the number of annual fatalities worldwide:
   a) Suicide - 815,000
   b) Homicide - 520,000
   c) War - 310,000
4. **We are often most afraid of the least likely dangers, and frequently not worried enough about the risks that have the greatest chances of affecting us**

Risk of a Stock Market Crash

- Much of the world's misfortune is caused not by the things we are afraid of, but by being afraid
- Imaginary terrors led to real tragedies on a massive scale
- We're no different when it comes to money
- Every investor's worst nightmare is a stock market crash
- Based on history, the maximum ASPI has ever lost is only 41% in 2008, whereas we had a 125% gain in 2009. Thereafter, more recently the maximum our ASPI has lost for a year is only 8%.
- The real risk is not that the stock market will crash, but inflation where our savings get eroded due increase in the cost of living.
- Very few people are worried about they might run out of money during their first ten years of retirement and not being able to maintain their living standard

Understanding the Financial Markets
In a lighter vein

John Bird and John Fortune