



Behavioral Finance

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← 105-120
WALL ST

*“There are three factors that influence
the market:*

Fear, Greed, and Greed.”

— Market folklore

Introduction

- Investors are mostly rational “wealth maximizers”.
- Often emotion and psychology influence decision making process.
- Behavioral Finance
 - Combines cognitive psychology with conventional finance/economy.
 - Tries to explain how reasoning errors influence decisions and market prices.

Introduction (cont'd)

- Cognitive psychology:
 - Study of how people think, reason, and make decisions.
 - Reasoning errors = cognitive errors.
- People think cognitive errors lead to market inefficiencies.
- Conventional finance theories cannot explain some “messy” events (bubble, crash).

Introduction (cont'd)

- Irrational behavior and/or investor emotion pushes prices away from fundamental values.
- Eugene Fama, founder of EMH, said:
 - Some events cannot be explained by EMH, but EMH shouldn't be abandoned.
 - Trades of some irrational investors are random and cancel each other out.
 - Therefore, market prices are not affected by these irrational investors.
 - Behavioral Finance is a part of EMH.

Anchoring

- Ideas/opinions should base on relevant and correct facts to be valid.
- Anchoring leads attaching (“anchoring”) our thoughts to a reference point even if no logic exists.
 - Anchoring on historical price

Anchoring (cont'd)

- Investment Anchoring
 - If a stock value declines sharply in a short time period, investors anchor on recent "high" stock price.
 - They believe price drop is good reason to buy a stock at a discount.
 - Drop of stock value due to
 - Inconstancy of market or
 - Change in fundamentals
 - e.g. loss of most important customer

Anchoring (cont'd)

- How to avoid:
 - Listen to devil's advocate.
 - Research company's fundamentals.
 - Use many benchmarks as possible instead one or two figures.
 - Be patient and don't overreact.

Mental Accounting

- Separate money into separate accounts divided by
 - different source
 - tax return, bonus, gifts, earning income
 - different intention
 - e.g. money for vacation, house
- Assign money to accounts often with irrational effect
 - e.g. "money jar" or fund for house/vacation and have high credit card debt.

Mental Accounting (cont'd)

- Why not use fund's money to pay credit card debt?
- Personal value:
 - Fund for house or child's college too "important" to give up.
 - Using "important" fund may increase overall effect.

**** Money is interchangeable ****

Mental Accounting in Investing

- Divide investments between safe and speculative portfolio
 - To have the feeling that some money (in safe portfolio) is "safe".
 - To prevent negative return of risky portfolio on whole portfolio.
- Note:
 - No matter separate portfolio or whole portfolio, result is SAME.

Confirmation and Hindsight Bias

- “Seeing is believing” not always true.
 - Mind tends to allow bias to process events and information.
- Confirmation bias:
 - Filter selectively and pay attention to info supporting opinion.
 - Investors seek investment idea that support their ideas/opinions.
 - Bias lead to faulty decision making due to one-sided information.

Confirmation and Hindsight Bias

- Example: Investors find “positive” info about a hot stock (growing cash flow), ignore “negative” info (loss of customers) to “prove” their stock pick is good.
- Hindsight Bias:
 - Belief that past events are obvious, even if it wouldn't have been possibly predicted.
 - Dotcom bubble
 - Current financial crisis
 - Hindsight bias is cause for overconfidence.

Confirmation and Hindsight Bias

- How to avoid:
 - Being aware of confirmation bias not enough.
 - Find someone as devil's advocate to contradict idea/opinion about investment
 - To get different viewpoints (e.g. benchmark)
 - To get unbiased information

Gambler's Fallacy

- Lack of understanding of probability can lead to wrong assumption/prediction.
- Past events do not change probability that certain events will occur in future.
- Other explanation:
 - An event has not happened recently, it becomes "overdue" and is more likely to occur.
- Example: Coin flipping
 - 20 coin flips with head up.
 - One thinks the next one will be head down.
 - But: Probability of head up is always 50%
 - Thus: Previous flip doesn't affect future flips.

Gambler's Fallacy (cont'd)

- Example: Slot machine
 - People believe this: Each loss brings them closer to jackpot.
 - Odd of winning is same at each pull.
- Example: Investing
 - Liquidate stock after a subsequent periods of increasing value...
 - Hold stock after a subsequent periods of decreasing value...
 - Opposite can be true...

Gambler's Fallacy (cont'd)

- How to avoid?
 - In investing environment, to buy/sell stock after assuming that value is going to rise or fall is irrational.
 - Instead: Do your homework by doing research using fundamental/technical analysis.

Herd Behavior

- Individuals follow rational or irrational actions of a group.
 - If alone, s/he may not use the same choice.
- Reasons:
 - Social pressure of conformity
 - Large group of people can't be wrong
- Example: Dotcom Herd
- Can affect financial professionals

Herd Behavior (cont'd)

- Can be very expensive since
 - You buy/sell stocks by following trends that lead to high transactions costs.
 - You lose stock value at the end.
- Remember: Overvalued stock may be due to optimism and not fundamentals.
- Solution: Do homework by researching info.

Overconfidence

- James Montier made a survey, written in "Behaving Badly."
 - 74% of 300 fund managers believe to deliver excellent job performance.
 - Almost 100% of 300 think to be average or better.
- Confidence: Trust in one's ability realistically
- Overconfidence: Overly optimistic judgment of one's control or knowledge

Overconfidence (cont'd)

- Terrence Odean (in his 1998 study):
 - Overconfident investors think to be better in picking best stocks and best times.
 - Overconfident investors do more trades than confident investors.
 - More trades lead to lower yield than market.
 - Can lead to excessive portfolio concentration
- How to avoid?
 - Accept that each day has different challenges and investment techniques need often refining.

Do we need Behavioral Finance?

- Helps investors to recognize their mistakes.
- Helps investors to understand reasons for their mistakes.
- Helps investors to avoid mistakes (hopefully).
- Helps investors to realize that their mistakes can profit others.

Tips to Applying Behav. Finance

- Diversify
- Minimize trading
- Learn from mistakes
- Be patient
- Do checklist
 - – Is this within my circle of competence?
 - – Is it a good business?
 - – Do I like management? (Operators, capital allocators, integrity)
 - – Is the stock screaming cheap?

Tips to Applying Behav. Finance

- Don't anchor on historical info/perceptions/stock prices
 - Keep an open mind
 - Actively seek out contrary opinions
 - Update your initial estimate of intrinsic value
 - Erase historical prices from your mind
 - Set buy and sell triggers

“Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ...Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.”

-- Warren Buffett