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Smart ideas about wealth

Investors behaving badly

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> ***The human mind craves clairvoyance, but anyone's ability to see the future is extremely limited.***
> Frederick L. Muller, CFA

If there were one area of life where one would expect emotion and irrationality to form no part it would be finance. The expectation would be that when it came to making financial decisions, individuals would act rationally and consider all available information in the decision-making process.

In fact, a substantial body of evidence gathered by academic studies over the years indicates that often this is not the case and there are many examples of irrational behaviour and surprising errors of judgment. As a result, a field of psychology known as 'behavioural finance' has evolved, that attempts to understand and explain why emotions and errors of judgment influence investors and the decision-making process.

Prospect theory

Studies carried out in 1979 by Professors Daniel Kahneman and Amos Tversky resulted in their 'Prospect Theory'. They found that contrary to expectations, people attributed different emphases to gains and losses and to different ranges of probability. Their studies indicated that the chance of making a loss has a far greater impact on investor behaviour than the chance of making a gain – in other words, investors are more distressed by the loss than they are made happy by the gain. Added to this, the context in which a scenario is presented to an individual affects how they will respond to it.

Kahneman and Tversky presented groups of subjects with a number of problems. One group of subjects was presented with the following problem.

***1. In addition to whatever you own, you have been given $1,000. You are now asked to choose* between:**

A. A sure gain of $500

B. A 50% chance to gain $1,000 and a 50% chance to gain nothing.

Another group of subjects was presented with another problem.

2. In addition to whatever you own, you have been given $2,000. You are now asked to choose between:

A. A sure loss of $500

B. A 50% chance to lose $1,000 and a 50% chance to lose nothing.

In the first group 84% chose A. In the second group 69% chose B. The two problems are identical in terms of net cash position if the 'guaranteed' option is selected; however, the phrasing of the question causes the problems to be interpreted differently.

Source: Daniel Kahneman and Amos Tversky (1979), "Prospect Theory: An Analysis of Decision Making Under Risk", Econometrica,.

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Subsequent research also found that investors are willing to take more risks to avoid suffering losses than they are to realise gains. Faced with a guaranteed gain, most investors are risk-averse, but faced with a guaranteed loss, investors become risk-takers (which might explain why it is not uncommon for gamblers to try to gamble their way out of debt).

Fear of regret

Behaviour known as 'fear of regret' has been identified by academics as applying as much to finance as to other areas of our lives. It is commonly accepted that individuals will tend to feel regret after having made an error in judgment and research indicates that this behavioural trait extends to investing too. The decision as to whether or not to sell a stock is often driven by whether the stock is showing a profit or a loss. One theory is that investors avoid selling stocks that have gone down in order to avoid the pain and regret of having made a bad investment. It is thought that this trait could in part explain investors' propensity to 'follow the herd'. Perhaps investors find it easier to buy a popular equity and rationalise its price going down by comforting themselves that everyone else owned it and thought so highly of it. Buying an out of favour stock is harder to rationalise if it goes down in value.

The confidence factor

People often confuse luck and odds with skill. Rationally we all know that the chance of rolling a six on a die is the same no matter how many times the die is rolled. Nevertheless, many people continue to find it difficult to accept some facts despite mathematical statistical proof.

Research has shown that generally we all tend to be overconfident in some of our abilities and investors are particularly overconfident in areas where they have a little knowledge. However, confidence does not necessarily translate into success. This overconfidence is not restricted to individual investors – analysts, stockbrokers, fund managers and financial advisers are all consistently overconfident in their ability to outperform the market, or to find the manager/choose the fund which can. The reality is that the vast majority fail to do so.

Interestingly, people often see other people's decisions as irrational while seeing their own choices as being entirely rational. Investors frequently trade because they believe that they have information known only to them, or to a select few, which they believe to be superior and relevant, when in fact it is not so restricted and is fully discounted by the market. Every speculative trade, as well as many ordinary trades, consists of two people who each think they know better than the other as they have the superior information. Yet they can't both be right.

"In summary, people trade for both cognitive and emotional reasons. They trade because they think they have information when they have nothing but noise, and they trade because trading can bring the joy of pride. Trading brings pride when decisions turn out well, but it brings regret when decisions do not turn out well. Investors try to avoid the pain of regret by avoiding the realisation of losses, employing investment advisors as scapegoats, and avoiding stocks of companies with low reputations."

Meir Statman ("Investor Psychology and Market Inefficiencies," Equity Markets and Valuation Methods, The Institute of Chartered Financial Analysts, 1988)

All is not lost

The good news is that such behaviour can be unlearned. The Bloomsbury wealth team recognises the emotional aspect of investing and how it affects clients who have been used to having their assets managed by so-called market experts and 'star' fund managers. Active management is designed to feed on our emotional responses to investing. The 'financial porn' with which investors are constantly bombarded reinforces the desire to follow the herd for fear of missing out, and continually confuses luck with skill.

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That is why any prospective new Bloomsbury clients are required to go through a fairly rigorous 'de-programming' process involving learning about our investment philosophy, which in simple terms ignores the 'noise', involves no attempts at market timing, employs low-cost pure asset class funds and a rigorous rebalancing strategy which forces the discipline of selling high and buying low. In monitoring our client portfolios and carrying out regular rebalancing reviews, whether markets are up or down from one day to the next is completely irrelevant. What matters is that our clients are invested according to their appetite for risk and their need for returns to meet their goals. Once the asset allocation has been agreed it is purely a matter of rebalancing back to that allocation on a regular basis.

Remove the emotion. Remove the ego (we don't claim to be clever enough to know where markets are headed, and even if we were why on earth would we share that knowledge with anyone else?) and the rest is simple.

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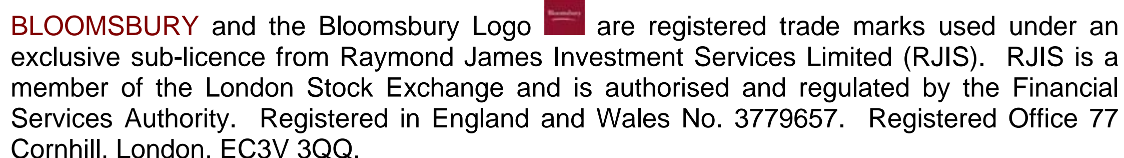

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