FINANCIAL PLANNERS CII CHARTERED

BreedElliott

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Behavioural Finance

In this newsletter, we aim to provide a practical introduction to behavioural finance and highlight the potential lessons for successful investing.

The behavioural biases we discuss are ingrained aspects of our human decision-making processes. Many of them have served us well as ways of coping with day-to-day choices.

But, they may be unhelpful for achieving success in long-term activities such as investing. We are unlikely to find a 'cure' for the biases, but if we are aware of them and their potential impact, we can avoid the major pitfalls.

This newsletter focuses on learning about our own biases, so that we can make smarter investment decisions.

What is behavioural finance?

Behavioural finance studies the psychology of financial decision-making and how emotions affect investment decisions. In our industry, we commonly talk about the role greed and fear play in driving stock markets. Behavioural finance extends this analysis to the role of biases in decision making, such as the use of simple rules of thumb for making complex investment decisions. In other words, behavioural finance takes the insights of psychological research and applies them to financial decision-making.

Over the past fifty years established finance theory has assumed that investors have little difficulty making financial decisions and are well-informed, careful and consistent. The traditional theory holds that investors are not confused by how information is presented to them and not swayed by their emotions.

But clearly reality does not match these assumptions. Behavioural finance has been growing over the last twenty years specifically because of the observation that investors rarely behave according to the assumptions made in traditional finance theory.

Established financial theory focuses on the trade-off between risk and return. However, behavioural finance suggests investors are overconfident with respect to making gains and oversensitive to losses.

Research in psychology has documented a range of decision-making behaviours called biases. These biases can affect all types of decision-making, but have particular implications in relation to money and investing.

A variety of documented biases arise in particular circumstances, some of which contradict others. The following sections discuss the key biases and their impact on investors.

Overconfidence

Psychology has found that humans tend to have unwarranted confidence in their own decision making. In essence, this means having an inflated view of our own abilities.

In practical terms, we tend to view the world in positive terms. While this behaviour can be valuable – it can help us to recover from life's disappointments more quickly – it can also cause an ongoing source of bias in money-related decisions.

For example:

- If we are overconfident, we may overestimate our ability to identify winning investments. Traditional financial theory suggests holding diversified portfolios so that risk is not concentrated in any particular area. Overconfidence may weigh against this advice, and we may become convinced of the good prospects of a given investment, causing us to believe that diversification is, therefore, unnecessary.

- As an overconfident investor, we might believe that we can exercise more control over our investments than we really do. In one study, affluent investors reported that their own stock-picking skills were critical to portfolio performance. In reality, they were unduly optimistic about the performance of the shares they chose and underestimated the effect of the overall market on their portfolio's performance.

- If we have too much confidence in our trading skills, we may trade too much, with a negative effect on returns. A number of studies have shown that more active traders earn lower returns than those who sit and hold.

- Overconfidence may be fuelled by another characteristic known as 'self-attribution bias.' In essence, this means that, faced with a positive outcome following a decision, we will view that outcome as a reflection of our ability and skill. However, when faced with a negative outcome, we attribute this to bad luck or misfortune.

Loss aversion

As already mentioned, established financial theory focuses on the trade-off between risk and return. Risk from this perspective means variability of outcomes and riskier investments should, broadly speaking, offer higher rates of return as compensation for higher risk. The theory assumes that investors seek the highest return for the level of risk they are willing and able to bear.

The idea of loss aversion includes the finding that people try to avoid locking in a loss. Consider an investment bought for £1,000, which rises quickly to £1,500. The investor would be tempted to sell it in order to lock-in the profit.

In contrast, if the investment dropped to £500, the investor would tend to hold it to avoid locking in the loss. The idea of a loss is so painful that we tend to delay recognising it.

More generally, investors with losing positions show a strong desire to get back to break even. This means the investor shows highly risk-averse behaviour when facing a profit (selling and locking in the sure gain) and more risk tolerant or risk seeking behaviour when facing a loss (continuing to hold the investment and hoping its price rises again).

A related issue is a tendency for emotions to sway us from an agreed course of action – 'having second thoughts.' The human desire to avoid regret drives these behaviours. Inertia can act as a barrier to effective financial planning, stopping us from investing and/or making necessary changes to our portfolios.

How we think about portfolios

Finance theory recommends that we treat all of our investments as a single pool, or portfolio, and consider how the risks of each investment offset the risks of others within the portfolio.

We are supposed to think comprehensively about our wealth. Rather than focusing on individual securities or simply our financial assets, traditional financial theory believes that we consider our wealth comprehensively, including our house, pensions, government benefits and our ability to produce income.

However, human beings tend to focus overwhelmingly on the behaviour of individual investments or securities. As a result, in reviewing portfolios we have a natural tendency to fret over the poor performance of a specific asset class or fund. These ‘narrow’ frames tend to increase our sensitivity to loss.

By contrast, by evaluating investments and performance at the aggregate level, with a ‘wide’ frame, we may exhibit a greater tendency to accept short-term losses and their effects.

Managing diversification

Whilst we understand the critical importance of portfolio diversification, behavioural finance research suggests we sometimes struggle to apply the concept in practice.

Evidence suggests that investors use naïve rules of thumb for portfolio construction in the absence of better information.

One such rule has been dubbed the ‘1/n’ approach, where investors allocate equally to the range of available asset classes or funds (‘n’ stands for the number of options available).

This approach ignores the specific risk-return characteristics of the investments and the relationships between them, as discussed in last month’s newsletter.

Investors have also been documented to prefer investing in familiar assets as they associate familiarity with low risk, e.g. investing just in the UK. The danger can be one of inadequate diversification.

Using (or misusing) information

Researchers have documented a number of biases in the way in which we filter and use information when making decisions. In some cases, we use basic mental shortcuts to simplify decision-making in complex situations. Sometimes these shortcuts are helpful, in other cases they can mislead.

Decisions can be ‘anchored’ by the way information is presented. For example, values such as market index levels can act as anchors. Round numbers such as 6,500 points on the FTSE 100 Index, seem to attract disproportionate interest, despite them being numbers like any other.

We are also more likely to be fearful of a stock market crash when one has occurred in the recent past or assume that the past performance of a fund is an indication of its future performance or cling to an initial judgement in spite of new contradictory information.

Managing the biases

It would be the height of overconfidence if we, as financial planners, claimed that we were immune to these behavioural biases.

We cannot cure the biases, but we can attempt to mitigate their effects through our advice process and the regular monitoring and reviewing of your portfolio.

Seeking to understand our clients’ future aims and aspirations, discussing investment risk in detail, earmarking funds for specific objectives, agreeing a benchmark asset allocation for each specific portfolio, rebalancing portfolios into line with the benchmark, playing devil’s advocate rather than just agreeing with what our clients say, etc. are all techniques we use to help our clients to make decisions in a more rational manner and improve the chances of investment success.

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Market	Value at the start of 2018	Current situation	Comments
Interest Rates (BOE base rate)	0.25%	0.50% at 31.07.18	The official bank rate is 0.5%
House Prices (Nationwide)	House prices increased by 2.6% in 2017	House prices up by 0.5% at 31.07.18	UK annual house price growth has softened to 2%
UK Share Prices (FTSE 100)	7142.83	7700.85 at the close on 30.07.18	The FTSE 100 climbs into 'positive territory' following the latest batch of company releases

Helping you to manage your money

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