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Equity Solutions

EQUITY IN A NUTSHELL

Five Key Questions to Understand Behavioural Finance

Introduction:

As we have written previously (Equity in a Nutshell issue N° 7: *An Introduction to Valuation*), "Equity investment or divestment decisions are based partially on expected future share price increases (or depreciation)." This approach has its limitations, as it ignores the different behavioural biases of each investor. These are numerous, as this document introducing around twenty of them proves!

What is behavioural finance?

Frequently misunderstood, sometimes disparaged, behavioural finance is the discipline, which attempts to explain all or some of the movements in stock prices by the behaviour of individuals. In other words, it simply applies psychology to finance. A strange subject that was only officially recognized in 2002 when the Nobel Prize in Economic Sciences was awarded to Daniel Kahneman, one of the founding fathers of behavioural finance. However, simple denial of the existence of behavioural tendencies in finance, does in itself represent a strong behavioural bias!

Behavioural finance, in contrast to classical financial theory, does not consider investors to be rational, but rather as individuals influenced by their emotions or even by their reasoning biases. Many are reluctant to accept this discipline as it is often considered complex, abstract, over-intuitive, etc., and particularly because it is likely to cast doubt on the decisions of sophisticated investors and professional advice.

We will therefore take a very concrete approach to the different tendencies, supported in this task by the fact that each of these has been studied using precise and factual data.

For the most sceptical readers, here are three examples:
- How would you choose between two identical restaurants with the same menu, prices and decor, one of which is empty, and the other full? And if your best friend had recommended the former? – ***Information cascade***
- 82% of those questioned(1) (as it happens, students) consider themselves to be amongst the top 30% of drivers (i.e. the least dangerous drivers). – ***Overconfidence bias***
- Managers questioned(2) on the same date in the EU, UK, Europe and Japan are consistently more positive for domestic shares than those in other markets. – ***Home/cultural bias***

Is this an important discipline?

In 1936, the economist Keynes described the way markets function with an analogy to the behaviour of individuals involved in picking the winner in a "beauty contest". As the winner is the person who picks the face chosen by their peers, participants are not interested in picking the most beautiful face, but focus on finding the one that will please the other participants. This approach is perfectly replicated by investors using the "consensus", which combines the expectations of financial analysts. Hence investors tend to bank on stocks likely to beat this consensus (or to see expectations revised upwards), and not just on those where the stock market value is significantly below the fundamental value.

Thus the concept of behaviour is apparent as soon as there is an attempt to identify the future behaviour of other investors, rather than estimating fundamental value.

There are therefore three parameters in the system for determining stock market valuation:
- Fundamental value (see Equity in a Nutshell N° 7: *An Introduction to Valuation*),
- Stock market mechanisms (capital flows, inclusion in/removal from an index, etc.),
- Elements of behavioural finance.

Behavioural finance is of particular interest as regards the private investor to the extent that the decision-making process is often easier to understand and a lot more "straightforward" (no investment committees, sectoral weightings, index replication, etc.) and therefore behavioural elements have a greater influence.

Getting to grips with this subject

Overall, behavioural tendencies can influence the famous risk/return issue in a number of ways: either by influencing the perception of risk or willingness to accept risk, or by their impact on the required level of return or targeted return, or even on the relationship between risk and return as they distort the choices.

(1) "Are we all less risky and more skillful than our fellow drivers?", Ola Svenson, 1981
(2) "Understanding the Equity Home Bias: Evidence from Survey Data", Norman Strong and Xinzhong Xu, 2003

There is no easy break down as behavioural finance is a truly vast area. Every aspect of behaviour can be taken into account: errors of judgment and individual or group emotions alike. Here we suggest four classification categories:
- Heuristics and cognitive biases: this groups together systematic errors in reasoning leading to decision-making errors or adopting the wrong behaviour,
- Emotional biases: this category includes all emotions leading to bias in the decision-making process,
- Decision biases: these are biases that are specifically linked to decision-taking,
- Social biases: these are the biases resulting from interaction with others.

How does this affect me?

As we can see from the categories listed above, these biases play a role at every stage of stock market investing: from how the stock market itself is perceived (and therefore the amount allocated to these investments), through portfolio construction, to portfolio management. So many choices made in markets are influenced by behavioural elements and misunderstanding these biases can rapidly lead to major errors.

Taking an example which is something of a caricature of portfolio management will enable us to identify some of these errors.

Simple assumption, let's imagine a private investor who only wants to invest a portion of assets in the stock markets, representing an amount considered "exceptional" or separate from future requirements. Such an approach represents a mental ***accounting bias*** giving rise to a different perception than if assets had not been segregated in this way.

Whilst still in the phase of portfolio construction, which stocks should be chosen? Is the portfolio diversified? Is it not subject to ***naive diversification*** causing it to be overexposed to interest rate changes or a geographical area, or, on the contrary, to reject volatile stocks which would nevertheless reduce its risk? Even if they are diversified, the positions chosen may suffer from ***home bias*** (overexposure to stocks in the investor's home country) or alternatively from ***habit formation*** (stock selection based on the usual criteria, investment in stocks frequently held in the past).

Stock selection should be made on clear criteria and avoid behavioural stumbling blocks such as:
- Copying the behaviour of a third party (in simple terms: ***information cascade*** if consciously adopted, ***mimetism*** if unconsciously),
- Estimating a company's quality based on one's own preferences ("I like the product, therefore the stock must be interesting") which represents a ***false consensus*** effect,
- Investment based on rapid and easy access to information on this stock (***availability heuristic***),
- Stock selection based purely on stock market performance over the last two or three years (***representativeness heuristic***).

In the best case scenario, all goes well. In the worst case scenario, the investor is subject to a tide of negative news. An investor who holds course shows a certain degree of courage, providing this obstinacy does not reflect behavioural biases related to decision-taking:
- Insufficient time (***limited attention***) to investigate the investment argument upstream of the investment and later,
- ***Selective attention*** which means that negative news flow is ignored,
- Priority given to some information (in particular, that which supports the viewpoint) due to the mass of information for handling and analysis (***cognitive overload***),
- Rejection or rationalization of news contradicting the investment thesis ***(cognitive dissonance)***,
- Disproportionate importance attached to the slightest good news in the stock ***(confirmation bias)*** or quite simply disproportionate ***optimism!***

So what can be done with a stock that has fallen in value? This relates to knowing when to accept losses, a subject already tackled in Issue N° 5 in December 2012, but which we can expand upon here. This acceptance is often late due to an ***overconfidence*** bias, and sometimes also due to egotistical reasons. Realizing losses in a stock that has fallen is even more difficult when there is a strong ***anchoring bias*** (reference price linked to the purchase price, historic high, etc., etched in the memory). Finally, studies have shown that there is a preference to hold on to stocks that have fallen in price and to take profits too quickly in those that have risen ***(disposition effect)***. The tendency to hold on to stocks is often linked to ***loss aversion*** (which may put a brake on risk-taking in investment) or to ***status quo*** bias (disinclination to reconstruct a portfolio).

We know that stock market losses are painful (around twice as high as the equivalent gain according to studies). So there is often great temptation to "recuperate" and to reinvest in a stock that has fallen. This can be summarized as ***commitment effect.***
In contrast, following a realized loss, there is a greater tendency to forget the stock to the extent of never again investing in it, however attractive it may be (***snake-bite effect***).

How to overcome my biases?

In the first instance, we should remind you that we have chosen to take a caricatural and negative approach. Thankfully some biases are positive (optimism, overconfidence, etc.) in particular, ***self attribution bias,*** which consists of attributing good performance to one's own skills and disappointments to uncontrollable external factors!

It would of course be pretentious (optimistic) to seek to change a reader's behaviour with just a few lines.

We cannot list all behavioural tendencies here, and even if we could, unfortunately awareness and experience of these biases does not make us completely immune to them (for example, it is not easy to fight against one's emotions). Nonetheless, knowing one's own tendencies allows one to erect safeguards before taking decisions on investments or disposals.

It is clear that financial markets create numerous situations, which can be used to highlight one's own tendencies (risk perception, profit target, etc.). Yet using the market in this way is expensive, as George Goodman (known under the pseudonym of Adam Smith) wrote as early as 1968: "If you don't know who you are, this (the stock market or Wall Street) is an expensive place to find out."

Conclusion

Behavioural finance remains a much-discussed discipline. Whilst we cannot prove that it contributes in performance terms, it is easy to list and understand a certain number of biases likely to influence investment decisions.

These biases apply to all investors, be they individuals or institutional, sophisticated or otherwise.

Steps should be taken to recognize one's own biases in order to erect safeguards when taking decisions, if one cannot eradicate them altogether.