

Behavioral finance

Behavioral finance is an emerging science that exploits the irrational nature of investors. The base of behavioral finance is that humans often depart from rationality in a consistent manner. Most of our investment decisions are influenced to some extent by our prejudices and perceptions that do not meet the criteria of rationality.

It's been a little over a year since the technology house of cards started to crumble: "Dot com" quickly became "dot gone" when it came to investor's money. What can account for such exuberance gone awry? Perhaps the answer lies in part in "behavioral finance," a relatively new and developing field of academic study that concentrates on irrational behaviors that can affect investment decisions and market prices. For decades, economists have speculated, theorized and argued about the "rational actor"--a completely logical creature who always makes the sensible financial choice. Now psychologists are weighing in, and they're finding that real people often don't act that way. "Psychology has a story to tell about investing, and it's different from the one economics tells," says Princeton psychologist Daniel Kahneman . These humans' flaws are often consistent, predictable, and can be exploited for profit.

Traps into which investors land

Too self-confident: Investors often ignore the role of chance, preferring to preserve an illusion of control by exaggerating both their own skill and the importance of that skill. The concept is called positive testing, which refers to the fact that good results impel people to conclude that the methods they employed to achieve such results are inherently sound. The problem is that they then reject alternate methods that might also work well, if not better. In the money management business, positive testing manifests itself frequently with respect to manager selection: it induces fiduciaries to retain winning managers or strategies even when the risks of regressing to the mean are acute, and to reject approaches that conflict with settled ways of doing business. People are overconfident in their own abilities, and investors and analysts are particularly overconfident in areas where they have some knowledge. However, increasing levels of confidence frequently show no correlation with greater success.

Too bold: Professional and amateur investors alike tend to have an "optimistic bias," believing that their chances are better than the next guy's. "This bias is the foundation of the whole stock-trading industry," says Kahneman. "Traders know that 50% of them must be below the median, but they all think that they're above average."

Too afraid of loss: "How much a stock cost shouldn't affect your decision to sell it, according to the traditional model," Kahneman notes. "but for real investors, how much they paid is very important. People hang onto their losing stocks because they don't want to feel the pain of cost-loss discrepancy, which refers to the fact that investors are more aversive to losses

than costs. For example, a manager who under performs his benchmark in a sharply rising market is less likely to be fired than a manager who under performs by the same margin in a falling market. The reason: trustees view underperformance in a rising market as a cost, whereas they view underperformance in a falling market as what it is — a loss

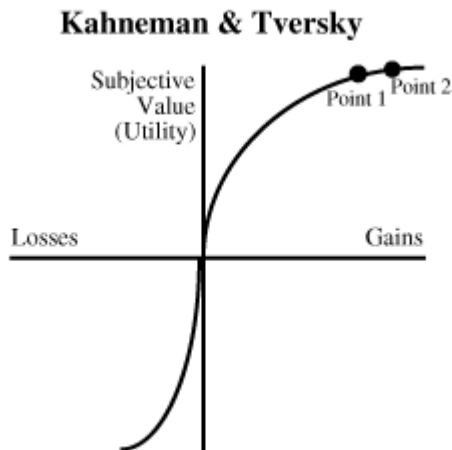
Too quick to trade: Kahneman reports that a forthcoming study shows that when an investor sells one stock and immediately buys another, the one that was sold does better by an average of 3.4% in the following year. People like to feel that they're actively bettering their financial situation--but, as Kahneman notes, "if you hold onto a stock for a while, your chances of making money on it are greater.

Causal reasoning: when confronting novel situations, people struggling to form a coherent view are heavily influenced by the order in which they receive conflicting information. The classic examples are juries, which numerous studies have shown ascribe excessive importance to the initial "facts" presented to them. A good example of causal reasoning in the investment world is the problem institutions run into when their first foray into an asset class — emerging markets, for example — goes poorly. If causal reasoning kicks in, it can take years, if not generations, for trustees whose first foray went poorly to commit additional sums to an asset class, even if the poor returns in question result from price declines that have made the asset class more attractive in the valuation sense

Status quo bias: researchers have coined a term to describe the behavioral underpinnings of herd behavior what they've found is that people tend to ascribe acute importance to recent trends, thus creating the preconditions for sustained market movements, the extreme form of which is a speculative "bubble." of course, following the crowd is rational in at least one respect: if the costs or difficulty of gathering independent information are excessive, then mimicking the behavior of others is sensible. A good example would be manager selection — a task that, if performed independently, is so time-intensive that some folks simply hire the manager with the most prestigious client list.

How people compare gains at different time points

Tversky and his colleague Daniel Kahneman argued in a path breaking 1984 paper recognized: in graphical terms, subjective value or utility is actually an asymmetrical function of the absolute size of an investor's gains or losses (see figure).



Subjective value of gain decreases as the monetary value increases. This frequently leads individuals making decisions much before the right time. Take the example of merger arbitrageurs- they make a good living because many investors place a higher subjective value on the initial dollars gained when a company whose shares they own becomes the subject of an announced deal than they do on the added dollars that might flow their way if they held their shares until the deal actually closed. In other words, the initial 50% profit that the archetypical widow makes when a stock she owns becomes a disclosed target has more subjective value to her than five times the 10% gain she forfeits by selling her shares to an arbitrageur after the deal is announced but before it closes. (point 1 in figure b denotes the price at which the widow sells to the arbitrageur; point 2 denotes the price the arbitrageur hopes to realize when the deal closes.) Of course, if the deal collapses, the person left holding the bag could slide a long distance down the sickeningly steep loss aversion curve in the southwest quadrant of figure b. It is precisely this prospect that induces most shareholders to sell at point 1 — and that inhibits many talented investors from becoming arbitrageurs. The best arbitrageurs may eat well, but they don't sleep well.

In layman's terms, various studies have concluded that behavioral finance postulates the following:

- Individual and institutional investors are susceptible to herd mentality, a tendency at the root of many bubbles and crashes;
- The pain of a dollar lost generally is much greater than the pleasure of a dollar gained;
- People tend to take a self-centered approach to investing. That is, they put emotional weight in the price they paid for the stock relative to its current position;
- Overconfident investors tend to trade too much and under perform the market;
- People tend to be more optimistic when the market goes up and more pessimistic when it goes down;

- People are afraid to admit an error in judgment and are thus more likely to sell winners in their portfolios than losers;

Usefulness: if these consistent human flaws can be predictable then it can be exploited for profit. This is where the behavioral finance comes in. Behavioral finance has evolved to attempt to better understand and explain how emotions and cognitive errors influence investors and the decision making process. As decision-making includes psychology and not many models take this into view, so many researches believed that the study of psychology and other social sciences could shed considerable light on the efficiency of financial markets as well as explain many stock market anomalies. Behavioral finance, with its roots in the psychological study of human decision making, documents how and why most investment managers are more confident than they should be, in their forecasting ability, why they do not process information efficiently, experience the illusion of control, do not act as if the choices they make come from a probability distribution, make different trade-off decisions depending on the current context, give undue credence to management and research gurus and hang on and even add to losing positions.

Conclusion:

What is the relevance of behavioral finance? Is it a study of the past decisions? Or is it forward looking? How can one benefit understanding behavioral finance and why is it gaining importance now? Financial advising is a prescriptive activity whose main objective should be to guide investors to make decisions that best serve their interests. To advise effectively, advisors must be guided by an accurate picture of the cognitive and emotional weaknesses of investors that affect investment decision making: their occasional faulty assessment of their own interests and true wishes, the relevant facts that they tend to ignore, and the limits of their ability to accept advice and to live with the decisions they make. In the long run behavioral finance would certainly help in building better models. By focusing rigorously on root causes, behavioral finance can help fiduciaries recognize conditions that are conducive to irrational behavior, avoid falling into "sub optimality traps," and exploit profitably the irrational actions of others.

"Only two things are infinite, the universe and human stupidity, and I'm not sure about the former." Albert Einstein. An investor can't be assumed to be a machine, always making logical calculations and uninfluenced by psychological factors. People trade not only for profit but for emotional and cognitive reasons as well. These aspects if factored could make the analysis more accurate and reliable. Knowledge of this area may also help an investor at a personal level as it makes them aware of the common mistakes they make.

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