Funds on FRIDAY

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Behavioural Finance: Why we are not rational.

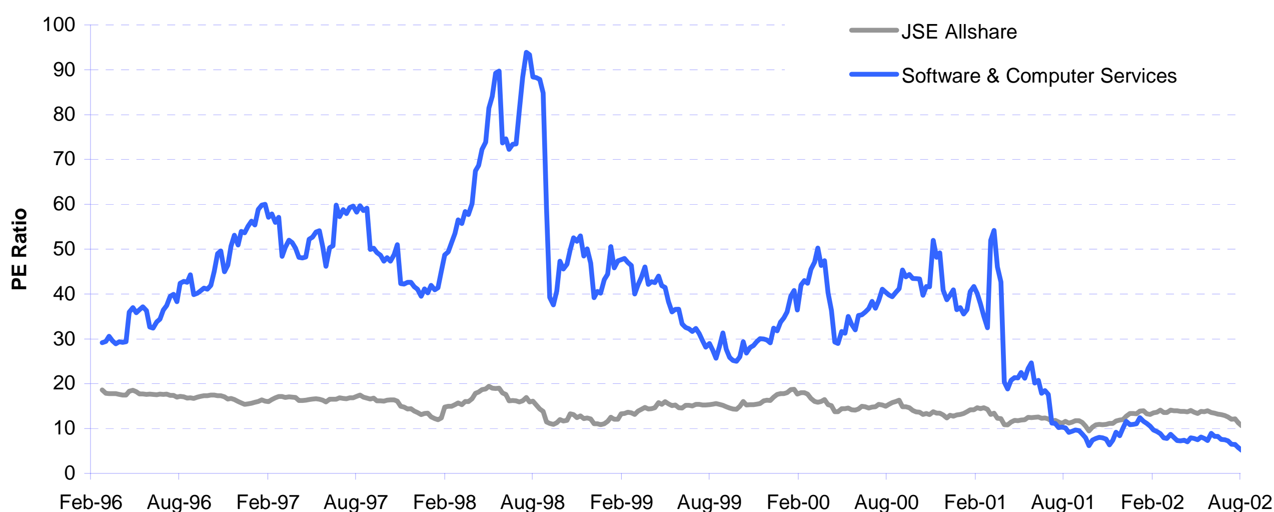
A question investment professionals and financial intermediaries field more than any other is: what is going to happen in the market tomorrow? People want to know why the market went up and if it will continue to do so, at other times they want to know why the market is down and how far it will fall. Our secret is that often, over the short term, we don't know.

Don't misunderstand me; investment professionals can usually identify good companies that will generate returns over the long term. We allocate assets to help generate excess returns and reduce volatility, but in the short term we will grudgingly admit that the market behaves irrationally and is usually impossible to predict.

Recent developments in a new field have helped our understanding of the underlying causes of this irrational behavior. In the past, investment theory centered on the assumptions of mostly rational investors and the rational behavior of financial markets. It assumed that the market price for a share is correct and that it takes into account, perfectly, all the current and past information in the marketplace. Clearly this is a fictitious situation. Momentum effects, overpriced stocks, bubbles and crashes all show this theory to be incomplete. What researchers are calling Behavioural Finance is quietly altering our understanding of the way markets work. Behavioural Finance attempts to take the more emotional and irrational side of the markets into account. By being aware of the effects and causes of irrational behaviour it tries to assist in making investment choices. It assumes that these irrational reactions, whether they are justified or even foreseeable, also play a role in moving the market and that ignoring them when considering investments is not prudent.

A prime example of irrational investor behaviour was the exuberant buying at ridiculously high prices that happened during the IT bubble followed by the extreme negativity towards the sector after its fall from grace. In hindsight people find it absurd that trading and prices reached such high levels, but during those times people were simply not behaving rationally. There was a herd mentality to investing. You either went along or you got left behind. This form of herd mentality is only one of many behavioural biases that are common to the investment landscape.

Graph comparing PE's of JSE and IT sector. The IT sector reached a peak PE of 93 before the crash.



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Behavioural Finance theorist Amos Tversky said: “It is not so much that people hate uncertainty – but rather they hate losing”.

Loss aversion is also a common bias in investor behavior. People display a tendency to place an asymmetrically greater weight on capital losses than on gains. They prefer to invest in instruments with a certain return over all periods rather than in a share/fund that may be very volatile in the short term, but is more likely to outperform in the long term. People require a much larger risk premium for investing in shares than we would rationally expect. This is part of the reason equity returns are so much greater than their fixed income counterparts.

Often investors overreact to loss and their reaction depends on their anxiety, sense of risk and their investment targets. In some cases clients become negative and shut down. They become totally risk averse in general, or they totally shun a certain asset class. An example of this was investor’s attitudes to offshore investments directly after the Rand staged an unexpected recovery starting in 2002. Foreign investments were shunned, even though the losses were mostly attributed to Rand strength and not global equity markets. Subsequently, many investors lost out on possible gains as global markets recovered and the Rand stabilised. That particular bias in still very evident in the market. Conversely, investors sometimes start taking on too much risk in an effort to recoup their losses. This situation can be seen as a desperate attempt to “get even”, much like drawing money from an ATM at the casino after suffering heavy losses at the tables. Both scenarios above can be wealth destroying.

The recent (ongoing) market correction is a great example of another common phenomenon. The global and local fundamentals remain strong. The IMF expects real global growth to be around 5% this year and earnings in the US and elsewhere is still high. Apart from that, South Africa doesn’t have a sub-prime market and few companies and almost no investors have any exposure to it. Despite this the market has been falling and already many investors are becoming nervous, thinking about, or actually, moving out of equities. People have a tendency to predict a long future pattern based on a short recent history rather than realize that the short recent history could be due to chance, mis-pricing or overreaction rather than to any emerging pattern. Ironically, bubbles and bursts are often due more to sentiment than any recognizable change in economic circumstances.

Investor overconfidence is another popular bias. People take care to choose reputable investment managers and companies. They invest in managed solutions that take long term views and whose express purpose it is to safeguard capital over the long term, but the moment the market takes a wrong turn they move their money or pull it out of the market, instead of trusting the investment manager. This adverse behavior often causes investors to pull out of the market too late and then re-enter the market too late as well, participating in most of the downside while missing large parts of the upside. This is the classic “sell low-buy high” trap investors fall into so often.

How then do we avoid or at least reduce the effect of these behavioural biases? The problem is that we are often not aware of them and we believe that we are behaving perfectly rationally. This means it is essential to try to recognize what biases you as an investor may fall prey to. A powerful tool in your arsenal is a financial advisor. A financial advisor has the express purpose to provide you with information and guidance that will help mitigate the more serious of your investing flaws. Ideally it should be a long-term partnership that reduces or eliminates those flaws that could be harmful. The end result should be a system of investing you feel comfortable with, and a plan that you can follow. Investing is not and should never be a game played on a monthly basis. Its goals and outcomes are focused on the long term and your plan should be structured in this manner.

Weaknesses in the behavioural finance model have kept it from becoming mainstream. The fact that it is not a predictive model and is based on “soft” issues, like emotions and psychology, has hindered its acceptance among investment professionals. The lack of a pricing model has also hampered progress because it means that while behavioural finance theory can explain why certain biases are common and what their effects are, its practical application in managing money is still limited.

Most of our behavioural biases are driven by fear. Fear of losing our money. Fear of not making enough money. These fears and many others drive our behavior. These fears are reasonable, but often their consequences are not. Controlling these fears and understanding the impulses they drive is what makes a successful investor.

“Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.” - **Warren Buffet**

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