

Understanding Behavioral Finance

Investors generally assume they make decisions based on rational judgment. However, a relatively new school of thought called behavioral finance questions this notion. Behavioral finance examines investors' propensity to stray from rational decisions due to emotional and psychological factors. In the wake of the last two bear markets, investors have begun to re-examine the long-held assumptions of modern portfolio theory. By integrating modern portfolio theory with behavioral finance, we gain a better understanding of the influence investor behavior has on stock and bond prices over market cycles. Such insight leads to more informed investment decisions.

Modern Portfolio Theory – A Snapshot

In the 1950's Harry Markowitz established the foundation for modern portfolio theory. This has since become the standard for portfolio construction. The basic tenants of this theory assume investors:

- have rational expectations – investment decisions are made through a logical, rational and unemotional process.
- are risk averse – the risk/reward trade-off is understood and investors prefer the least amount of risk possible per unit of return.
- view individual investments within a portfolio context – the benefits of diversification are recognized and individual holdings are examined according to their role within the portfolio.¹

Operating within this environment, investors construct portfolios using expected return, standard deviation, correlation, the efficient frontier and a host of other statistical measures. Such tools were naturally derived by the left side of the human brain, the side responsible for objectivity, rationality and analytical thinking. One of the major shortcomings of modern portfolio theory is that it ignores the right side of the brain that houses emotion and subjectivity.

Behavioral Finance – A Snapshot

The real world is messier than modern portfolio theory assumes. This is especially true in the context of extreme bull and bear markets when emotions run high. Investor psychology warps the tenants of modern portfolio theory into a differing set of assumptions that influence asset prices. Behavioral finance assumes investors:

- have biased expectations – preconceptions and biases influence investment decisions.
- are loss averse – losses are felt more intensely than gains.
- view investments on a stand-alone basis – stocks are viewed as winners and losers not for the roles they play in a diversified portfolio.²

Behavioral finance assumes investors are not always rational and tend to be vulnerable to certain hazards. This can lead to improperly priced assets. Below is a sampling of five key behavioral finance concepts and their influence on the financial markets over the last decade.

1. **Representativeness** is the notion that past winners will continue to be winners and past losers will continue to be losers.³

Effect: The prices of winners become overly inflated and the prices of losers become too depressed.⁴ Representativeness was at the root of the recent real estate debacle. Investors purchased second and third homes in anticipation of ever higher prices. This eventually led to toxic mortgages, troubled banks and the near paralysis of the global financial system.

2. **Overconfidence** can destroy wealth as investors often fail to acknowledge they may be wrong.

Effect: Overconfident investors are surprised when things do not work out as they expected.⁵ Generally, they place too much stock in their abilities, knowledge and education. Over the last few years many sophisticated hedge fund managers employed excessive leverage due to overconfidence. Accordingly, many have been forced out of business as big bets went against them.

3. **Convoy Behavior** or “herding” occurs when investors make decisions based on the actions of others.⁶

Effect: Convoy behavior can lead to asset bubbles as prices rise above fundamental values. During the technology bubble, investors ignored fundamental analysis and piled into internet stocks because everyone else was doing it.

4. **Hindsight Bias** stems from reflecting on history with the benefit of knowing what happened after the fact.⁷

Effect: This perception leads to overconfidence. Investors convince themselves they are more investment savvy than they really are and fail to learn from past mistakes. Both the tech bubble and the real estate debacle are obvious now, but some claim to have predicted them in advance when in reality they failed to take action at the time. Such lack of introspection can lead to future failures.

5. **Anchoring** occurs when investors fail to incorporate new information into their expectations.⁸

Effect: Investors hold onto an asset even though the reason it was originally purchased is no longer valid. Instead of selling the position, they are “anchored” to their previous beliefs and fail to take advantage of other opportunities. After the technology sector imploded some investors remained enamored with the sector and held on in hopes of a quick recovery that never came.

Additional behavioral finance concepts include regret avoidance, cognitive dissonance, aversion to ambiguity, regret, money illusion, self control and many more.

Over the decades, we have coached many of our clients through the pitfalls addressed in behavioral finance. Having just come through a trying period, we think it pertinent to address these concepts as they are as relevant today as they have ever been. From our perspective behavioral finance is crucial because it sheds light on the emotional drivers of booms and busts. In particular it helps explain why certain assets (stocks, bonds, real-estate, commodities or market indexes) soar above or plummet below rational, fundamental valuations.

As your investment manager, part of our task is to recognize and take advantage of the anomalies created when assets deviate from fundamental valuations due to behavioral and other factors. Melding modern portfolio theory with behavioral finance helps us determine when to sell current positions and when to pursue new opportunities.

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Endnotes

¹ *Managing Investment Portfolios: A Dynamic Process*, Third Edition, John. L. Maginn, CFA, Donald L. Tuttle, CFA, Jerald E. Pinto, CFA, and Dennis W. McLeavey, CFA, editors.

² Ibid

³ *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*, by Hersh Shefrin.

⁴ Ibid

⁵ Ibid

⁶ *Financial Analyst Journal*, September/October 2005, by Martin L. Leibowitz

⁷ *Goals-Based Investing: Integrating Traditional and Behavioral Finance*, by Daniel Nevins, CFA

⁸ *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*, by Hersh Shefrin.