A Guide to Behavioural

Professional Capital

Advising Professionals Every Step of the Way

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Introduction

Behavioural finance studies the psychology of financial decisions and is especially important in the investment arena. It explains how investors can sometimes act irrationally or from an emotive viewpoint, with ingrained and unhelpful biases in their approach.

If investors understand these better it is likely they will make better decisions, avoid painful financial errors and reduce their propensity to suffer losses. Learning about behavioural finance is an important step for investors, even for experienced investors.

The most relevant area for investors starts with an appreciation of how biases can often play a big part in investment decisions.

These biases are often hard-wired within us, with valuable benefits in our everyday life. However, when it comes to money matters, they can have the opposite effect.

Understanding and spotting these biases when they arise can make a positive difference to outcomes.

About This Guide

Behavioural finance is an incredibly rich and detailed subject. This short guide covers a couple of key points.

One is to give you a feel for the subject and to produce examples of where it fits into the investment process. It is not intended to provide an in-depth analysis.

The second is to show how an understanding of behavioural finance connects to traditional finance theories. And from there, how this can influence the decisions taken towards an effective financial planning approach.

In some cases, the examples that follow will overlap so that some of the behavioural characteristics described will encompass more than one 'bias' or trait' that may exist.

Loss Aversion

Perhaps the most common trait amongst investors is their emotional connection with incurring losses. Significant research has been done around this factor.

There are two main aspects to focus on;

- The first is the fear of losses.
- The second is the behaviour in reaction to losses - once occurred.

The fear of loss can lead investors to choose the wrong investments for their situations or pursue an inappropriate strategy.

People are known to apply more emotional weight to losses than to gains, in other words the pain of loss is considered greater than the pleasure of a profit.

In some cases, this mismatch can be significant – which can produce an aversion towards otherwise appropriate options, as the loss-fearing investor chooses investments which have the wrong risk/reward levels to meet their needs.
In terms of how investors can behave when losses are incurred, there are some strange and irrational traits which can often appear.

A good example is when an investor waits for an investment to return to its original purchase price or value. For example, an investment is purchased for £10,000 but after a few years has fallen in value to £8,700. The investor decides to hang onto the investment until it gets back to £10,000 and then sell it.

This is irrational as there is no connection to the question of whether the investment remains the best place for that £8,700 – at that time.

Does the investment still fit with the wider strategy, is there a reason it has fallen or is it simply normal market volatility, are there better options now available for the money and so on?

The historic purchase price has limited or zero relevance to the current position or prospects. It makes no sense to attach any importance to that figure.

There is further evidence that investors do not like or feel comfortable with locking in losses. It is as if the paper loss at any given moment is unreal. Whereas the actual loss should the sell order proceed is real. Yet, the fact is that the loss has already occurred, regardless of whether it is 'locked in'. Deciding to hold onto the investment simply to avoid 'formalising' the loss makes no sense.

Again, investors behaviour can be irrational in this respect.

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Over Confidence

Studies show that individuals tend to act with over-confidence in a wide range of areas, believing their abilities are greater than they are.

A good example would be in forecasting future investment outcomes or picking a winning investment, such as a share or a fund.

This is something individual investors should be wary about, but the good news is that this is not restricted to amateurs, with studies also showing this trait is rife amongst professionals as well…

For example, one study of professional fund managers showed that 74% of those managers considered their skills above average, 26% considered themselves average. None considered themselves below average.

This area is made more complex by the inclusion of luck. For example, a confident investor may make an investment decision, such as betting on a big rise in shares in the near future. They stake their money accordingly and a big rise in shares takes place. This outcome is great for that investor, who then assumes a position they were correct in their analysis which led to their decision.

However, the investor may have been right simply due to chance. They are no more or less qualified after their success than they were before it to make successful predictions, yet their confidence will tend towards a belief they *are* more qualified.

Likewise, studies and research show that when investors have a success, they will usually put this down to their skill, but when they suffer a setback this will be down to bad luck.

Over confidence can lead to taking the wrong positions in certain investments assets, a mistaken belief that the investor can time the market and, most often, a tendency to trade too much – an aspect known as over-trading.

All of these have proven to be exceptionally detrimental in the long run in terms of the investment returns.

Take emotions out of the equation and conventional finance theories show that investors who succeed – over periods of time – are the ones who follow a strategy of diversification, which has at its centre an understanding that investments, markets and, indeed, economic conditions are largely unpredictable.

The key is to pursue a diversified portfolio approach. One that has a respect for the unpredictable position investors face.

Herding

Herding is relevant when decisions are taken based on the safety net of the crowd, i.e. because everybody else is following a certain pathway, that must be the best pathway to follow. This shows up time and time again in markets.

Examples appear in economic history all the time; notably with 'tech' stocks' in the late 1990s when investors piled into technology company shares simply on the basis that this was what everyone else was doing.

The fundamentals of whether this was a good place for one's money were thrown out of the window.

This particular example is loosely related to a related bias which is known as 'regret' – the idea that if you don't do something you may regret it. In the case of technology shares, the regret would be that a co-worker or family member or friend invested, making big gains, whilst you missed out.

Information Matters

The ability to correctly identify the information that matters (and the information that doesn't) is an important factor and one that behavioural psychologists have studied in depth.

Biases appear in respect of information, on a regular basis.

For example, there is a bias known as anchoring. This is where an individual anchors their view or decision to some form of information which has limited relevance.

In investment terms a good example would be a stock market index number. Big, round numbers tend to have more meaning in people's minds. When the Dow Jones Index hits 20,000 or 25,000 this can have an impact, yet it really has no meaning, as opposed to any other number.

Yet we can anchor around this number as if it gives us something tangible.

The same is true of market crashes; research shows the more recent a market crash occurred the more it plays in the minds of investors.

The irony in that example is that a crash should, in theory, make investing more palatable, not less so. This is because prices are lower. Yet, the anchoring effect can make investors more fearful and less likely to invest.

This is all down to how recently the last serious market downturn was. This is sometimes known as availability bias – where more recent information or news is given more prominence.

Each of the above are categories of some the various biases that commonly exist in the investment world and can adversely influence investors decisions. This can lead to sub-optimal outcomes.

There are other biases which make up the subject and investors can gain a significant advantage by learning more about all of these.

And working with a professional adviser who understands how they fit into the process.

How to Use an Understanding of Behavioural Finance to Your Advantage

Conventional finance theories, such as the capital asset pricing model (CAPM) or the efficient market hypothesis (EMH) are built on firm foundations.

However, there are flaws. This is because the theories generally work on the basis that people will act rationally. Yet, over time this has shown not to be the case.

It is when people, or in this case investors, act irrationally that mistakes happen, unnecessary losses are incurred, or the individual ends up with sub-optimal outcomes. In investment terms, these comprehensive theories encourage the use of a diversified portfolio approach aligned to an individual's risk profile.

If investors can recognise the behavioural finance applications, then the two theories can be combined.

This can help with:

- ✓ Determining the investment strategy and plan of action.
- ✓ A reference point for the decision-making process and how to take decisions.
- ✓ Providing an underpin and support to decisions, both short-term and long-term.
- ✓ How to invest in relation to one's goals.
- ✓ Deciding when and how to rebalance a portfolio.
- ✓ A checkpoint when things don't go according to plan.
- ✓ Having a more robust financial planning approach.

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The value of investments may go down as well as up and you may get back less than you invest.

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