

Investment Tutor

More than just fear and greed

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Can gaining an insight to those psychological factors that drive markets make you a better investor? Chris Wagstaff, Head of Investment Training at Aviva Investors, looks at the evidence.

Since the early 1960s, academics and market practitioners alike have debated the Efficient Markets Hypothesis (EMH): the proposition that share prices continually reflect all publicly available information, react rationally and instantaneously to market news and move independently of past share price movements in a random, or unpredictable, manner.

Behind the hypothesis that markets are price efficient lies the assumption that investors are rational, risk adverse, wealth maximisers who possess a limitless capacity to source and process all relevant information accurately. The implication of the EMH, that one cannot consistently outperform the market on a risk-adjusted basis, unless just plain lucky, has loomed large over the active fund management industry which seeks to do just that.

However, the existence of persistent mispricing and the emergence of predictable patterns and trends in many markets, has, along with often entertaining episodes of exuberance, bubbles and crashes that pervade stock market history, given rise to a new way of thinking about the determination of share prices and share price movements.

Behavioural Finance, the fusing of finance theory with psychology, rather than making simplifying assumptions about how investors approach investment, instead analyses the way in which elementary mistakes, bias and a reliance on the actions and opinions of others systematically enters into investor decision making processes, so helping to explain why what we observe in markets is frequently at odds with the EMH.

Behavioural finance suggests that most pricing anomalies in financial markets stem from representativeness: investors applying rules of thumb and mental short cuts to simplify the complex reality of investment decision making in an uncertain environment. As very few investors have the capacity and cognitive ability to sift through and accurately process all relevant information and attribute probabilities to the occurrence of events, most tend to do whatever's intuitive.

However, intuition doesn't always serve us well. For instance, there is a tendency to infer and extrapolate trends from what could simply be a series of random events, without questioning the reasons for the apparent trend, whether in a company's earnings record, a fund manager's track record or recent share price moves. For example, whilst there is a 67% probability of 20 flips of a fair coin generating a run of four consecutive heads, many people, severely underestimating the odds, would intuitively attribute such a run to the skill of the coin flipper rather than luck and infer a trend from what are a series of random events. Seeking out recently available information that confirms, whilst rejecting information that is



By Chris Wagstaff

Head of Investment Training and Development
Aviva Investors

contrary to, the investor's thinking is also commonplace. By failing to distinguish between random events and genuine trends and, therefore, luck and skill, especially in respect of fund manager track records, sub optimal decision making results.

Another regularly observed bias is overconfidence: an over exaggerated belief in one's own skill or a misplaced belief in having an informational advantage over other investors. Overconfidence typically leads to investors placing too much faith in their stock selection and forecasting skills, which, in turn, results in the holding of undiversified portfolios exposed to significant stock specific risk and excessive trading, which invariably culminates in underperformance. Overconfidence also manifests itself in investors failing to incorporate new price sensitive information, such as company earnings announcements, into their original forecasts. By remaining anchored to their forecasts, share prices under react to this price sensitive information, providing a potentially profitable opportunity for those investors who capitalise upon this misplaced overconfidence.

Traditional finance theory assumes investors are risk adverse and view risk symmetrically. In reality, most investors are loss averse and view profits and losses asymmetrically. For instance, when faced with a guaranteed loss, of say £100, or an even chance to enter into a double or eliminate the loss gamble, most investors prefer to gamble. However, when faced with the choice of securing a guaranteed sum of the same magnitude or taking the same double or quits gamble as before, most would opt for the guaranteed sum. Whereas risk seeking behaviour is observed in avoiding the loss and risk adversity in securing the gain, loss aversion is evident in both cases. In fact, research shows that the pain associated with a loss is 2.5 times the pleasure associated with a gain. Loss aversion may, therefore, explain why many investors take profits on their winning investments too soon and hold on to their loss making investments for too long. Excessive monitoring of share prices can also lead to increased loss aversion as an over exaggerated view of share price volatility is formed.

Although behavioural finance provides a useful insight to understanding how investor mistakes systematically enter into investment decision making processes, it does not provide a guaranteed path to riches. Despite a behaviourally aware approach to investment being a smarter way to invest, playing the rational investor when irrational price movements are dominating markets can prove to be an act of folly, as the dot.com boom of the late 1990s demonstrated. Moreover, whilst markets may not be perfectly price efficient, ironically they remain largely unpredictable and, therefore, hard to beat, principally as a result of the systematic errors investors make.