BEHAVIOR FINANCE

Are you Rational or Normal?

> *"A lot of what underlies smart [investing] is the fact that investors are not broadly rational. They're often their own worst enemies, subject to making emotionally driven decisions and overreacting in the short term. This can result in them selling at the wrong time—when equities fall—and missing out on the long-term returns offered by being invested in the markets. These strategies are specifically geared to limit some of the peaks and valleys to the portfolio overall. We talk a lot about that with clients in that context." (Robert Nestor, Managing Director, Blackrock).*

According to conventional financial theory, people are, for the most part, rational "wealth maximizers". However, there are many instances where emotion and psychology influence our decisions, causing us to behave in unpredictable or irrational ways.

Human beings often can act in what appears to be irrational and unexpected ways when it comes to money and finance.

There are generally two schools of thought when it comes to an investor's finance behavior – Standard Finance and Behavior Finance. They both augment each other. Another nuance of this is a distinction that is made between **Rational Investors** and **Normal Investors**. NOTE: We all are both and we all do both.

Standard Finances is concerned with risk and return metrics of investing like Standard Deviation, Sharpe Ratios, BETA, Alpha, Sortino and Treynor Ratios, all metrics that tell us something about the risk or return characteristics of an investment or a portfolio. The use and goal of which is to try to find the most return for the least risk. In standard finance people act rationally.

In Behavior Finance people act normally. Behavior Finance tries to explain the difference between what standard finance would predict people will do and what they actually do. For instance, someone holds on to a stock because they love the products but the stock is dropping in price and there are other investments that could be better.

Here are some common examples from Behavior Finance.

> **Mental Accounting** – This refers to the tendency for people to separate their money into separate accounts based on a variety of subjective criteria, like the source of the money and intent for each account. According to the theory, individuals assign different functions to each account, which has an often irrational and detrimental effect on their consumption decisions and other behaviors.

Although many people use mental accounting, they may not realize how illogical this line of thinking really is. For example, people often have a special "money jar" or fund set aside for a vacation or a new home, while still carrying substantial credit card debt or not fixing the car. Simply put, it's illogical or not rational (and even detrimental) to have savings in a jar earning little to no interest while carrying credit-card debt accruing at 20% annually.

Confirmation Bias – Confirmation bias occurs when people filter out potentially useful facts and opinions that don't coincide with their preconceived notions. It affects perceptions and decision making in all aspects of our lives and can cause us to make less-than-optimal choices. Seeking out people and publications with different opinions from our own can help us overcome confirmation bias and make better-informed decisions. It explains why people tend to seek out information that confirms their existing opinions and overlook or ignore information that refutes their beliefs.

Endowment Effect – This describes a circumstance in which an individual values something which they already own more than something which they do not yet own. They perceived greater value occurs merely because the individual possesses the object in question. Investors, therefore, tend to stick with certain assets because of familiarity & comfort, even if they are inappropriate or become unprofitable. The endowment effect is an example of an emotional bias. It doesn't matter if the object in question was purchased or received as a gift, the effect still holds. People who inherit shares of stock from deceased relatives exhibit the endowment effect by refusing to divest those shares even if they do not fit with that individual's risk tolerance or investment goals, and may negatively impact a portfolio's diversification

Anchoring - Anchoring is a behavioral bias in which the use of a psychological benchmark, or rule-of-thumb carries a disproportionately high weight in a market participant's decision-making process. One consequence is that market participants with an anchoring bias tend to hold investments that have lost value because they have anchored their fair value estimate to the original price rather than to fundamentals. As a result, market participants assume greater risk by holding the investment in the hope the security will go back up to its purchase price. Another example might be where one holds an investment for values necessary to accomplish a certain objective, such as achieving a target return or generating a particular amount of net proceeds. These values are unrelated to market pricing and cause market participants to reject rational decisions.

Prospect Theory – "Loss Aversion" - Prospect theory assumes that losses and gains are valued differently, and thus individuals make decisions based on perceived

gains instead of perceived losses. Also known as "loss-aversion" theory, the general concept is that if two choices are put before an individual, both equal, with one presented in terms of potential gains and the other in terms of possible losses, the former option will be chosen.

For example, consider an investor is given a pitch for the same investment by two separate sources. One source presents the investment to the investor, highlighting that it has an average return of 12% over the past three years. The other source tells the investor that the investment has had above-average returns in the past 10 years, but in recent years it has been declining. Prospect theory says that though the investor was presented with the exact same investment, she is likely to buy the investment from the first source, who expressed the investment's rate of return as an overall gain instead of the advisor presenting the fund as having high returns but also losses. There's nothing rational about this but it is normal.

SOURCE: Investopedia – http://www.investopedia.com

For example, consider an investor is given a pitch for the same mutual fund by two separate financial advisors. One advisor presents the fund to the investor, highlighting that it has an average return of 12% over the past three years. The other advisor tells the investor that the fund has had above-average returns in the past 10 years, but in recent years it has been declining. Prospect theory assumes that though the investor was presented with the exact same mutual fund, he is likely to buy the fund from the first advisor, who expressed the fund's rate of return as an overall gain instead of the advisor presenting the fund as having high returns and losses.