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“Behavioural Finance”

We review a recent CFA Institute publication and two other books which provide insights into behavioural finance theory. This field has become an important alternative to modern portfolio theory, some of whose assumptions are unrealistic.

Introduction

“Behavioural Finance and Investment Management” by the Research Foundation of CFA Institute, edited by Arnold S. Wood (2010), is an excellent perspective on the field of behavioural finance. It assembles leading academic and practitioner views and discusses this topic from several vantages which we review: 1/ behavioural finance in the context of modern portfolio theory (Statman and Thaler), 2/ fear and irrationality (Zweig and Shiller), 3/ lessons from neuro-economics, i.e., the operation of the brain (Sapra and Zak), and 4/ the sociology of markets (Mauboussin). We also make note of two related books: “Behavioural Investing: A Practitioner’s Guide to Applying Behavioural Finance” by James Montier (2007) - a comprehensive reference source, and “Stumbling on Happiness”ⁱ by Daniel Gilbert (2006) – how the mind works (or doesn’t).

Behavioural Finance in the Context of Modern Portfolio Theory (Meir Statman and Richard Thaler)

Meir Statman describes the four building blocks of modern portfolio theory (MPT) and the alternatives offered by behavioural finance theory (BFT):

1/ In MPT, investors are rational, but in BFT they are “normal”. Loss aversion and hindsight bias are two of the more important behavioural traits which detract from rationality.

2/ In MPT, markets are assumed to be efficient, but not so in BFT. Efficiency means a stock’s price is always equal to its fundamental value. Studies have found, however, that typically only 20% of changes in stock prices are due to fundamental value and that many changes in indices occur with no change in fundamentals at all.

3/ In MPT, investors build portfolios using mean-variance analysis, but in BFT portfolio construction is goal-oriented and involves quite different risk orientations for different types of investment objectives.

4/ In MPT, return is determined mainly by “beta” (a measure of risk), but in BFT return is a function of a wide array of factors, including market cap, value/growth, and momentum.

Statman makes the point that, while mean-variance and CAPM are very elegant models, they are not very realistic in their assumptions and have consequently declined in usage. He also notes that the frequent criticism of BFT is not appropriate – its theories are elegant too, more complicated, but also more realistic.¹

¹ Stephen Ross’ *Neoclassical Finance*, Princeton University Press (2005), summarizes the main challenge to behavioural finance. The efficient markets hypothesis (EMH) does not depend on average investor rationality – just sufficiently smart, well financed, and

Richard Thaler discusses the evidence legitimizing BFT and concludes that the term will in the future become a redundant phrase, as in “what other kind of finance is there?” His conclusions also include:

1/ Investigation of BFT has led to models which explain aggregation of individual behaviour, grounded in both psychology and economics - important because opponents of BFT often argue that individual actions are irrelevant in aggregate,

2/ BFT theory on loss aversion explains the long-standing puzzle of why the long-term equity risk premium is so high, and

3/ As noted earlier, BFT empirical research has uncovered frequent and widespread anomalies which question market efficiency.

Fear and Irrationality (Jason Zwaig and Robert Shiller)

Jason Zweig and Robert Shiller discuss fear and irrationality, respectively. Zweig has written and spoken extensively on fear as an impediment to rational actions. A number of his webcasts are available on the CFA Institute website and are worth watching. His chapter discusses how fears are often mistaken or inflated, causing investors to react reflexively - often to their detriment. Shiller, author of “Irrational Exuberance” (2000), discusses irrationality in the stock market and housing market. He points out that while psychology is very important, it alone does not cause bubbles. Rather, bubbles result from a series of elements including: participating factors, amplification factors, cultural factors, and not the least, psychological factors.

Lessons from Neuro-economics (Steven Sapienza and Paul Zak)

Steven Sapienza and Paul Zak are Professors at the University of Southern California and Claremont Graduate University respectively. In this chapter they prescribe lessons for money managers. Neuro-economics –the study of which brain regions make decisions – permits the explanation of behavioural anomalies. One lesson from this excellent chapter concerns “anticipation of rewards”. In this, we learn that the brain (in different places) encodes reward data, motivates effort to seek rewards, and engages emotions for positive results in a rush typically associated with drug use. The lesson to investors is to be aware of how our brains influence our actions. Without discussing all the lessons contained in the chapter, suffice it to say, even a brief understanding of the operation of the brain would very likely improve our investment decisions.

The Sociology of Markets (Mike Mauboussin)

Mike Mauboussin’s article is about the sociology of markets - who invests and what they invest in. It cites examples which explain how sociological factors have caused large scale anomalies in market performance:

motivated investors. Stephen Ross notes that anomalous empirical observations seem to have some or all of the characteristics: 1/ they are small, 2/ they are statistically suspect, 3/ they are fleeting and 4/ they are not replicable. Statman’s and Thaler’s arguments in support of BFT appear to stand up very well.

1/ The significant outperformance of U.S. small caps over large caps from 1926 to 1979, followed by the opposite in the 1980s and 1990s,

2/ The resumption of the small cap outperformance pattern due to the growth in hedge funds from 2000 to date, with their propensity (vs. that of mutual funds) for small and mid cap stocks, and

3/ The Alan Greenspan fixed income “conundrum” in 2003-4 during which Fed tightening strangely led to a fall in long rates.

The article concludes that financial institutions and agents matter a lot in asset pricing.

“Behavioural Investing: A Practitioner’s Guide to Applying Behavioural Finance” (James Montier)

James Montier, author of “Behavioral Investing”, is a value investor with a strong behavioural psychology background. In this book he summarizes an immense body of research on behavioural investing and adds insights of his own, all of which, in my opinion, make this book a valuable reference on this topic.²

The book discusses how the brain works (reflexively vs. reflectively). As Montier says, “welcome to the human condition”. It identifies some 22 types of biases and the most common behavioural investment mistakes. It reviews a wide range of topics including: group decision making (as well as group failures and how to prevent them), fallacies of modern finance (the transient nature of alpha, beta, and style factors - growth and value), and the nature, predictability and progression of bubbles (from South Seas to Dot Com).

The book discusses an important area of behaviour psychology - happiness - what motivates people (correctly or incorrectly). This section notes that happiness does not equate to money but relationships, fulfillment, reflection, and physical well-being. Or as the extensive literature on happiness puts it: social rewards, superior work outcomes, and personal benefits.

“Stumbling on Happiness” (Daniel Gilbert)

The above last comment on happiness highlights the importance of this single topic. Montier frequently quotes Daniel Gilbert on happiness, leading to our final note on a book which is a favourite of mine. Daniel Gilbert, the author of “Stumbling on Happiness” (2006) is Professor of Psychology at Harvard. The book cites an extensive literature on behavioural psychology - some 300 papers and books. Needless to say, I would highly recommend it.

Maybe relating one excerpt will suitably capture the essence of Gilbert’s insight. Of all living creatures, humans have the ability to contemplate the future - thanks to their unique frontal lobe, gained in our evolution from apes. There is no better gift from nature. It allows us to contemplate and calculate the utility of future scenarios, asses multiple outcomes, and include what we have learned from past mistakes. Despite this unique gift, we happily fill in details we can’t recall, we often make up what we want to believe, and we

² A review of this book is available on the Brandes Institute website at: <http://www.brandes.com/Institute>

are heavily influenced by the more recent events, giving less weight to the distant past. Ultimately, using this unique gift effectively requires conscious effort to overcome our natural biases.

While this last book is mainly on behavioural psychology and is not centered on investing, it is an excellent complement to other readings on the topic.

Conclusion

As a final comment, I have been very fortunate in my career to have met some of the above authors (mainly at conferences, but also through correspondence and writing reviews of their literature). These include: Meir Statman, Josef Lakonishok, Jason Zweig, Robert Shiller, Mike Mauboussin, James Montier, and Daniel Gilbert. I would recommend following literature on behavioural investing, and add, if the opportunity presents itself, try to meet them first-hand. They are among the leaders in this important field of behavioural investing.

Gilbert, Daniel (2006) *Stumbling on Happiness*, Alfred A Knopf.

Montier, James (2007) *Behavioural Investing: A Practitioner's Guide to Applying Behavioural Finance*, John Wiley & Sons.

Wood, Arnold S. (editor) (2010) *Behavioural Finance and Investment Management* by the Research Foundation of CFA Institute.