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Behavioral Finance and Money Decisions

Lowell Hansen - CERTIFIED FINANCIAL PLANNER™

I was introduced to Behavioral Finance back in 1998 when I marketed a fund run by Russ Fuller and Dr. Richard Thaler. Dr Thaler was the professor of Finance at University of Chicago and went on to win the Nobel Prize in Economics for his work in the area of Behavioral Finance.

My time spent with him was fascinating as he discussed how psychology plays a part in investing. One of the areas is overconfidence. They have an investment strategy that plays on the overconfidence bias that analysts have on their opinions of the companies they follow. Professor Thaler would use this overconfidence as a means to gain an upper hand on beaten down stocks.

This also plays out with the individual investor. There was a study that was published around 2000 that looked at the investment behavior of men versus women. They were able to access trading activity for a discount brokerage firm and broke those trades down based on the sex of the trader. They determined that men traded their accounts significantly more frequently than women. As a result of the increased trading, there was a dramatic drop off in performance. The study went on to conclude that men, because of their overconfidence, traded their accounts more than 3x than women who tended to behold their positions over long periods of time.

Dr Thaler states "What we've found is that there are classes of situations where investors make systematic errors and those create buying opportunities," he says. "We classify those errors into two categories, overreaction and underreaction."

The lesson here is that increased trading may work in the short-run, however, over time is less likely to outperform a buy and hold strategy.

There is another observation in behavioral finance that is of particular importance in this time when the stock market is at an all-time high. This is called "anchoring". It is when we become anchored to a price and a drop from that price appears to be a bargain. This is used in retail. A store can advertise an item at 50% off of the retail price. You immediately think you are getting a steal when actually the item was priced at 200% above its actual value.

Tesla stock is a great example of this. Tesla reached an all-time high of $883 per share back in January of this year. The stock closed at the time this was written at $714. Roughly $170 off the high or a nearly 20% discount. Investors became excited to step back into Tesla stock. However, even at

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the 20% discount, it is trading at 1141x earnings! Wildly expensive!

Another bias that I'll mention as it relates to investments is Recency Bias. This is a cognitive and information processing bias where investors overemphasize the most recent events than those in the past.

A real-world example of this is that trip insurance increases shortly after a plane crash when the likelihood of a subsequent plane crash is statistically minimal.

In the investment world, it plays out when investors chase an individual stock or asset class that is in favor today versus reviewing its longer-term trend.

WHY IS ALL THIS IMPORTANT?

Simply knowing our weaknesses will help us navigate the future. Most humans are hardwired to be bad investors. We are emotional and experience several cognitive biases and heuristics that can influence us to make costly financial decisions. We accept that and create the proper game plan (i.e. defenses) to help us make good decisions under uncertainty, stress and fear.

"As a famous American baseball player Yogi Berra once said, 'Predicting is difficult, especially about the future"

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