Behavioural Finance

Combining markets, investments and psychology

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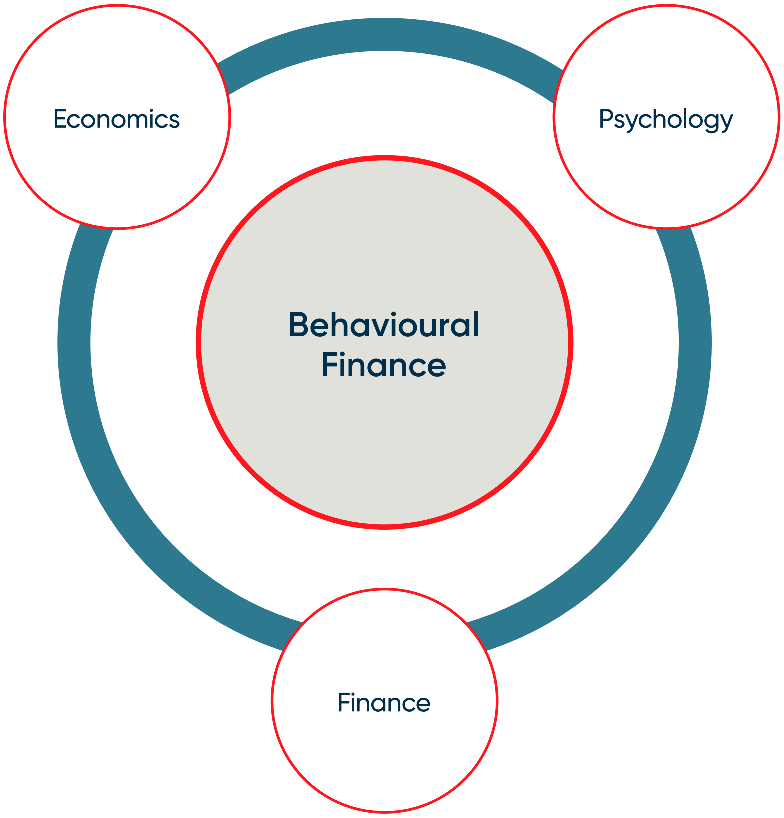
Behavioural finance (BF) resides at the intersection of economics (markets), finance (investments) and psychology. It studies the impacts of psychological, cognitive, emotional, cultural and social factors on the financial decisions of individuals. It affects every phase of life, from how investment beginners plan their financial projects and future plans, to how retirement-age investors approach a change in strategy with caution.

BF fills the gaps of traditional economics and financial theory by focusing on a better understanding of how humans deal with money and perceive risk. Contrary to the more traditional approach – which assumes that all investors are fully rational and process relevant information equally well – behavioural finance assumes that people act in line with their beliefs, their biases and their personal emotional filters.



For many investors, seeking advice from a financial advisor is often deemed the best solution for mitigating the occurrence of behavioural biases that could result in undesirable financial decisions. As the traditional role of the advisor is transitioning towards giving goal-based advice (and intercepting bias), BF suggests that this approach better supports investors experiencing uncertainty.

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Behavioural finance's main findings

There are 10 crucial tendencies that provide compelling insights into the psycho-economic drivers behind investment decisions.

1 **Herding**: This occurs when an individual relies on the wisdom of the masses to make a decision, foregoing their own individual analysis. Investors will buy a popular stock when its price soars without asking themselves if it has maybe become too expensive.

2 **Recency**: Recent events are fresher in our memory and tend to have a disproportionate impact on our decisions. This usually results in poor market timing decisions such as chasing the hottest trend (which relates to herding) or selling right after a big market correction. Media outlets constantly striving to publish sensational news leave the impression that action is needed right now.

3 **Mental accounting**: Mental accounting is the foundation of goal-based advice and investments. It states that people who save tend to have projects or specific financial goals in mind, like travelling the world or purchasing a cottage. They try to project how likely their savings will contribute to achieving their goals. People like to think there is a clear correlation between their savings and the likelihood of reaching their goals. The shortfall risk (the probability and impact of not reaching a goal) is much more significant to these investors than market risk is because the latter is harder to make sense of, particularly over long-term horizons.

4 **Loss aversion**: The objective to avoid investment losses is much more powerful than the drive to achieve equivalent gains. Loss aversion can also lead to poor market timing, as an investor may decide to keep a bad investment in their portfolio to avoid a loss. Loss aversion bias is often combined with recency bias: to put an end to the pain experienced after a major market correction, and investor may choose to sell just as markets are about to rebound. Loss aversion bias is usually triggered during bouts of market turmoil, amplifying its impact.

5 **Anchoring**: The tendency to create a reference point in order to make solid decisions is natural and (occasionally) useful, but only if the anchor is relevant to the situation. In finance, anchors can become detrimental to the decision process as they focus on past events. Examples of anchoring biases in finance include:

- Investors focusing on a price paid for a specific asset rather than its potential over a relevant investment horizon.
- Investors refraining from investing in a specific stock believing the timing is bad as prices reach new historical highs.
- Investors only following the S&P 500 as a barometer for the economy in general, ignoring other indicators such as bond markets, volatility or important economic figures.

6 **Salience**: This refers to our tendency to pay too much attention to a given attribute of a situation though other attributes may be way more important. In finance, investors with this bias will prefer a stock or a fund with a positively skewed return distribution because their attention is drawn to the salient high payoff state. However, all relevant information about its risk-return profile should be considered.

7 **Representativeness**: We often make predictions based on past experiences because the current situation feels familiar. Investors with this bias think that if markets suddenly drop by, say, 20%, then it will inevitably be followed by a sharp comeback. This is done without trying to understand what caused the drop and whether these factors are likely to remain.

8 **Overconfidence**: There is a widely held belief that history repeats itself. Young investors may be prone to overconfidence, especially if they began investing during a bull market. If they've been successful in the recent past, they will expect to be in the future as well. The fact that they may not have witnessed significant losses could also play a part in the lack of loss aversion. Overconfidence often commands disproportionate risk-taking and a reluctance to face reality when investments turn sour.

9 **Hindsight**: Those who believe they have a crystal ball suffer from hindsight bias: the misconception that, in hindsight, one "always knew" that they were right. They don't realize that predicting the past is easy. For example, it's easy to think that the great financial crisis could have easily been predicted as real estate was showing signs of a bubble.

10 **Home bias**: A fear of the unknown and the hassle associated to learning about other markets or opportunities is a strong deterrent for foreign equities investments. This results in an overallocation to domestic equities, which an investor may believe they know more deeply but does not realize that it lacks diversification.

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Adding behavioural finance to investment advisors’ toolkit

There are common actions and advice that advisors can leverage to help mitigate the unwanted impacts of investors’ behavioural biases on their financial decisions.

Actions and advice advisors can leverage to help mitigate unwanted impacts of clients’ behavioural biases*

More effective	Have a long-term view and strengthen clients’ trust
	Focus on goal-based advice and help clients prioritize their objectives
	Implement a strong management discipline to avoid surprises
	Increase portfolio diversification
	Advise clients to stay calm and stay invested in turbulent periods
	Improve clients’ risk tolerance assessment
	Avoid news binging
	Provide a customized service
Less effective	Reduce investment expenses

This list is inspired by the results of a recent survey of U.S. investment advisors (reference available upon request).

The intensity and prevalence of behavioural biases vary among generations. Loss aversion is the top concern for Baby Boomers, who are close to retirement if not already retired. Home bias is less worrisome for Gen X and Millennial investors, who are generally more connected to global issues. However, their consumption of information via individually tailored social media or news outlets means that the likelihood they will exhibit any hindsight or overconfidence biases is considerably higher.

Our parting words of wisdom are these: be aware of your own biases! Although it may be easier said than done, you can always keep a checklist of questions to refer to. Asking yourself, “Am I seeking only positive information?”, “What could make this a bad investment?” or “Am I just following a hot trend or is this a real opportunity?” could all be useful reframes you need to make better financial decisions.

Adding BF practices to their toolkit enable investment advisors to provide better guidance, mitigating the negative impacts of their clients’ behavioural biases.

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