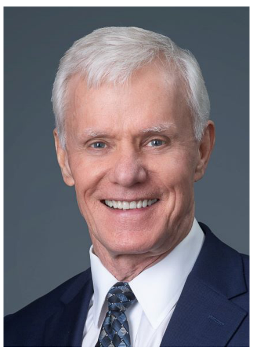
The Stan Clark Financial Team

Behavioral Finance

The relationship between human psychology and financial decisions: A conversation with Stan Clark



The following is a story based on many conversations I've had about investing – and the theory and practical applications of a concept known as *behavioral finance*.

Behavioral finance explores the relationship between human psychology and financial decisions. Its main lessons are that, contrary to what is taught in most economics classes and business schools, markets are anything *but* efficient or rational.

As you read this story, you'll get an idea of what is wrong with most investment methods; how human psychology constantly leads to making mistakes that cost money; and what you can do to avoid those mistakes and outperform long-term market averages.

Your investment horizon should be 10, 20 or 30 years away. It will take you only 15 or 20 minutes to read this story. I think you'll find it intriguing – enjoy!

Stan

How behavioral finance helps you avoid common financial mistakes and keeps your portfolio ahead of the crowd

I was about five minutes into my treadmill run at my gym when Dave, a man I knew from a board I worked on, clambered onto the treadmill beside me and began his run. After a couple of minutes he turned to look at me, shrugged and said, "This reminds me of investing. You run as hard as you can and you never get ahead; you just stay in the same place."

"I know what you mean," I replied. I was going at a nice even pace, so I could talk without gasping – I was in it for the long run. "As a Wealth Advisor I see people, even experts who should know better, making the same mistakes over and over again."

The trap of buying low and selling high

"Really?" Dave said. "What sorts of mistakes?"

"One of the biggest mistakes they keep making is trying to time the market," I said. "Trying to get into the market when they think it will go up and getting out of the market when they think it will fall."

"But that's what you're supposed to do," said Dave. "You buy low and sell high, or else you lose."

"Believe it or not, Dave, most of the time when people try to do that, they end up making exactly the wrong moves at the wrong time. They lose money, or make nowhere near as much as they ought to."

"I'm guessing that you do better," said Dave. "So how do *you* time the market?"

"I don't think anybody can time the stock market reliably. From day to day the market fluctuates wildly in response to a huge number of influences, such as natural disasters, extreme weather, economic or political news, oil prices...you name it. Anybody who thinks they can predict that is fooling themself."

"Maybe," said Dave, "but I know at least one advisor who's been kicking butt with his predictions for the last two years."

"Let me know how he's doing after 10 years. Anybody can get lucky for a short while. But I don't know of anyone who's been able to successfully time the market over longer periods. I don't think anybody can – but that doesn't stop them from trying.

> "Anybody can get lucky for a short while. But nobody's been able to successfully time the market over longer periods."

So what's the answer?

"Some people think that by getting out of the market temporarily they will reduce risk," I continued." But if you try this, you'll most likely end up losing out on a lot of growth. And worse, your money will be eroded by inflation over time. It's true, equities seem risky, but there are ways to mitigate the risk. You have to keep in mind that although the market fluctuates from day to day, it has produced a strong upward trend for the last 200-plus years – despite a number of boom and bust cycles."

I could see I had him thinking, so I laid out the story of behavioral finance: possibly the greatest and most fruitful theory ever conceived to explain how people continually make investment decisions that cost them money. Often, big money.

"Behavioral finance is fascinating because many of its findings run counter to conventional beliefs and thinking in economics and finance. The investment industry has been slow to incorporate these findings, so it's an advantage for those who do. It explains much of how we got into the great recession and global financial crisis of 2008 and, on a smaller scale, why most people don't do as well as they should with many of their financial and investing decisions."

Dave took a sip from his water bottle. He was well warmed up on the treadmill now, but I noticed he had slowed his pace so he could focus a bit more on what I was saying. He seemed to be getting it so I went on:

Lucky at evolution, unlucky at investing

"Behavioral finance combines the theories of finance and economics with studies of how people actually behave in real life. One of its main findings is that we humans are not anywhere near as rational as we like to think we are. Our intuition has almost no feel for probabilities; we're not great at predicting the future; and we're influenced by the emotional side of our brain far more than we realize. This results in systematic, repeated errors in how we think and act in relation to our finances. Some of the very traits that made us one of evolution's greatest success stories conspire against us when it comes to investing in the stock market.

"Knowing about these errors can give you a great advantage. Over the long term you can get better returns than most other investors, simply by avoiding their common financial mistakes."

Dave nodded, then looked at me with a puzzled expression. "This sounds interesting and it seems to make a lot of sense, but I'm not sure I understand. What kind of mistakes are you talking about?"

"Well, Dave, you've likely heard of people who have made fortunes in stocks, and likely, also, people who have lost nearly everything. You've seen how the stars of the industry – analysts, fund managers, investment advisors and others – rise up because of remarkable results. But inevitably, after a few years, they end up shining less brightly, bringing in mediocre results, or even worse. But while they *are* stars, individual investors and the media flock to them.

> "Over 15 years, if your investments earned an average of 8%, you would make 100% more profit than someone whose investments earned 5%."

"You probably also know of people who've received hot tips on stocks that couldn't fail, but did, and others who've missed golden opportunities by avoiding 'bad' stocks that ended up performing brilliantly."

"Well, sure, but are you telling me there is something I can do about that?" Dave asked. "Have you found something that works?"

"I think so," I said.

Documented biases that affect our investing decisions

There have been over 200 documented cognitive biases that affect our thinking and decision making. A summary of some of the more important ones are as follows:

- We get overly influenced by a small number of observations. Our intuitive brain evolved to make snap decisions to help us survive in hostile environments. Our brains are wired to reach quick conclusions on very little information, so it's very hard for us not to.

- We are overly influenced by recent events and those that happened directly to us. Conversely, we are much less influenced by what happened a while ago and to others, even though these could help us make far superior decisions.

- We tend to be overly optimistic and confident in our abilities. This is particularly true when attempting to forecast the future.

- More information and analysis increases our confidence, but often does little to improve the accuracy.

A number of the more significant biases are listed below:

***Anchoring effect**: The tendency to rely too heavily, or "anchor," on a past reference or on one piece of information when making decisions.*

***Availability heuristic:** Estimating what is more likely, based on what is more available in memory. These memories tend to be vivid, unusual, or emotionally charged.*

Availability cascade: A self-reinforcing process in which a belief gains credibility through public repetition ("repeat something long enough and it will become true").

Bandwagon effect: The tendency to do (or believe) things because many other people do (or believe) the same. Related to groupthink and herd behavior.

Confirmation bias: We tend to search for or interpret information in a way that confirms our preconceptions.

Clustering illusion: The tendency to see patterns where none exist. We actually have a part of our brain dedicated to seeing patterns.

Herd instinct: The tendency to adopt opinions and follow the behaviors of the majority to feel safer and to avoid conflict.

Hindsight bias: The inclination to see past events as being predictable (sometimes called the "I-knew-it-all- along" effect).

Mere Exposure Effect: We tend to like things just because we are familiar with them. Given the choice of investing between two companies, we favour the one we've heard more about.

Money illusion: We tend to focus on the nominal value of money, rather than on its purchasing power.

Neglect of probability: The tendency to completely disregard probability when making a decision. Our intuition has almost no feel for statistics; we are far more influenced by anecdotal stories. Optimism bias: The tendency to be overly optimistic about the outcome of planned actions.

The way most people invest

"First," I said, "let's take a look at how most people pick stocks and other investments. Most fund managers, advisors and analysts I know follow what I call a 'prediction approach.' They try to predict the future – of a specific company, of the economy, or of the stock market as a whole. They study economic data and do in-depth analysis of businesses and their competitors, customers and suppliers. They study charts to try to make sense of masses of data; they scrutinize financial statements, interview company heads, listen to colleagues and other experts, and look at what the rest of the investment industry is doing. Then, full of confidence, they make their choices.

"This all seems very logical and rational; it makes people feel comfortable that they've 'done their homework'. And it seems like something worth paying for. Would you agree?"

Dave nodded again. "Well, yes, of course it does," he said. Then with a smile he added, "But I have a feeling you're about to tell me I'm wrong."

"Well, I'm not going to say you're wrong for feeling that way. Let's just say you're human," I replied with a laugh. "But there's one small problem with this approach. It just doesn't work very well.

"Using this method," I continued, "the great majority of professional money managers go on to perform worse than the averages and most individual investors do worse still. This has been shown time and again, in study after study. Over the past 10 years the average mutual fund in Canada underperformed the market by 3.0% compounded per year.

"That 3.0% might not sound like a lot, but it adds up over time. Other studies have shown that poor market timing causes investors to underperform by another 1% to 2%, simply because they get into and out of the market at the wrong time.

"Over 15 years, if your investments earned an average of 8%, you would make 100% more profit than someone whose investments earned 5% – just 3% less. And you would have 170% the profit of someone who averaged returns of 4% – just 4% less. Those are small differences in performance, but whopping differences in results!"

How behavioral finance reveals the problems most investors face

Dave was aghast: "You mean all that information causes them to make mistakes? And it costs them that much?"

"I know it sounds counter-intuitive," I told him, "but behavioral finance has documented over 100 different biases people have that explain why this happens. The important thing to know is this: We

Overconfidence effect: Excessive confidence in one's own answers. For example, for certain types of questions, answers that people rate as "99% certain" turn out to be wrong 40% of the time.

Post-purchase rationalization: The tendency to persuade oneself through rational argument that a purchase was a good value.

Recency effect: The tendency to weigh recent events more than earlier events.

Disregard of regression toward the mean: The tendency to expect extreme performance to continue.

Restraint bias: The tendency to overestimate one's ability to show restraint in the face of temptation.

Semmelweis reflex: The tendency to reject new evidence that contradicts an established way of thinking.

Wishful thinking: Forming beliefs and making decisions according to what is pleasing to imagine, rather than reason or evidence.

are not very good at forecasting the future, yet nearly all of us think we are better at it than we actually are. We are either overconfident in our own ability to predict, or in some guru's tea-leaf reading.

"Overconfidence is one of the worst traits because you tend to be overconfident that you're *not* overconfident. Do you see what I mean? It's a tough, tough problem. The worst possible person to deal with is someone who doesn't know what he doesn't know. There's no doubt that the most dangerous predictions come from those who are most confident in them."

Dave wiped his face, and I did the same. Then, in unison, we both grabbed another sip of water. I chuckled to myself, thinking how deeply ingrained it is in us to follow the crowd.

"Okay, you've got me hooked," Dave said. "Tell me more."

"Well, to show how poor the experts are at forecasting, consider how dismal investment analysts have been at estimating company earnings. Company earnings are the key 'bottom line' number that analysts perform all their research on in an attempt to predict. In a study covering more than 94,000 estimates over 24 years, analyst earnings estimates were off, on average, by an amazing 44%! That is a huge error for something so important.

"And the crazy thing is that, although their actual ability to forecast is poor, they seem to have enough successes to fool themselves and others into thinking they are actually good at it."

Dumb-luck genius

"So an analyst or a fund manager makes some predictions, gets lucky and has some success, and we call him a genius. Is that what you mean?" Dave asked.

"Exactly, Dave. They become our expert. They have all the information. They're an eloquent speaker and writer. They feel confident, and we feel overconfident in them to make the best choices for our money. Then the crowd all starts thinking the same and the confidence builds on itself.

"And this is when mistakes happen. Overconfidence and crowd psychology cause some stocks to get priced too high. If a company gets on a roll for two or three years, people think it's going to last forever, but it almost never does. If you own those overpriced stocks and they start to fall, investors quickly lose their confidence.

"So, half the battle is simply to avoid overpriced stocks. That's what I mean by avoiding common financial mistakes. By avoiding overpriced stocks, which as a group tend to produce poor returns, you can increase your returns. Do you see what I mean?"

"I think so," said Dave. "I think you're telling me not to try to be a genius at predicting what can't be predicted; instead, to focus on avoiding the errors that others make, and simply stay away from overpriced stocks."

How to avoid losers

"Exactly. By avoiding more of the losers you will come out a winner over time. You can do even better by putting an emphasis on owning stocks that most people ignore and which are priced too low. You see, it actually works both ways."

"Well, that sounds good, but how do you actually do that? How do you tell which ones are overpriced and which ones are priced too low?"

"There are several ways, and most of them involve comparing the price of a stock to some basic underlying measure, such as the company's earnings, dividends, sales or book value. These are numbers which are fairly clear cut and readily available. So, you simply buy stocks whose prices are low compared to those measures, and avoid stocks whose prices are high compared to them."

"That sounds too simple," said Dave. "Why doesn't everyone just do it?"

> "Our emotions and faulty intuitions really take hold, so we twist our logic and go against solid statistical evidence, in favour of what feels good to us."

"That's a great question, and behavioral finance helps explain that, too. One problem is there's a lot of noise and randomness in the real world. I mentioned how these underpriced stocks tend to give better returns than the overpriced stocks. The problem is that not every underpriced stock gives better returns. The world's just not as predictable as that.

"By chance, it turns out that the occasional overpriced stock does very well and sometimes an underpriced stock bombs. It happens just often enough to fool people into continually buying overpriced stocks and avoiding underpriced ones. All they need is a couple of overpriced winners to make them think they are being successful, even if, over time, they really aren't.

It shouldn't be a popularity contest

"You see, part of the problem is that overpriced stocks tend to be the 'popular' stocks that everyone loves, so there is a great temptation to buy them. Our emotions and faulty intuitions take hold, so we twist our logic and go against solid statistical evidence in favour of what feels good to us.

"Remember, we have an irresistible urge to jump to conclusions based on recent events, and to put far too much emphasis on short-term trends of two or three years. We don't realize that pure luck and chance can produce a string of good results for a poor manager, or a string of poor results for a great strategy. We have to be on guard to resist the temptations to make decisions based on feel-good stories and short trends.

"When you step back and look at the facts over the long-term trend, it is very clear: Overpriced stocks, as a group, tend to do poorly and underpriced stocks tend to do better.

"When you ask, 'Why doesn't everyone just do this?' you have to think about the many areas in our lives where our emotions and temptations cause us to do things we shouldn't, or to not do things we should.

A good story, though inaccurate, can be irresistible

"The emotional part of our brain is so powerful that it has a strong tendency to get carried away by a good story when you are researching a company, even if you know about the tendency for underpriced stocks to do better. There are chemicals produced in our brains that irresistibly direct many of our actions, especially when rewards are involved. We are being guided by chemicals that are as powerful as cocaine. Now that's scary!"

"Hey, you know, this kind of reminds me of the story of the Sirens," said Dave.

"The Siren?" I asked.

"No, the Sirens, with an s," said Dave. "It's from the old Greek classic *The Odyssey*. I learned about it back in high school, and I always thought it was a fascinating yarn.

"The hero of the story is the Greek king, Odysseus. He's really smart – he's the same guy who came up with the idea of the Trojan Horse. Well, in *The Odyssey* he's captaining a ship and he wants to hear the song of the Sirens. But everyone knows their song is so overwhelmingly beautiful that it drives mortal men temporarily mad. When ships sail past, the sailors go crazy and let their ships smash up on the rocks.

"But Odysseus figures out that if he gets his crew to chain him to a mast, and then to fill their ears with wax, he'll be able to hear the Sirens but won't be able to do himself any harm. Meanwhile his crew won't hear their singing and will sail safely past. I always thought that was brilliant. And it popped into my head because when you think about it, Odysseus realized he wasn't strong enough to resist the Sirens, so he needed a way to protect himself from the pull of his emotions. That's like what you're saying: We need to find ways to take our emotions out of our investment decisions!"

"You've nailed it," I replied. "In investing, one trick is to use a disciplined approach to picking your stocks that keeps you from getting involved in the details of companies, which otherwise would distort your decision-making, and draw you into the deadly seas of the investing world.

"Dave, in many different professions it's been shown that systematic, disciplined models make better decisions than subjective human forecasters. As one analyst put it: 'Models beat human forecasters because they reliably and consistently apply the same criteria time after time... Models never vary... They are never moody, never fight with their spouse, are never hung over... and never get bored. They don't favour vivid, interesting stories over data. They never take anything personally. They don't have egos. They're not out to prove anything.

Trust your instruments

"Models follow rules. But people are always tempted to break or bend them, so it takes considerable discipline to stick with a set of rules, especially when the media and the market is clamouring for you to do something else."

> "When your entire financial future is at stake, what would you rather have on your side — a confident but unreliable 'gut feel' for the market, or a rules-based model with a long track record of success?"

"You may not know this," said Dave, "but I'm a pilot and we have a rule that helps keep us safe when things get hairy: "Trust your instruments". When you're in an aircraft and there is little or no visibility to help you orient yourself, it's easy to believe – to be 100% convinced – that you are flying straight and level when, in fact, your instruments are telling you that you are banking sharply, in a dive, or even upside down. If you go with what your senses tell you, you'll crash – many pilots have. But if you trust your instruments, you will almost always be safe."

"That's a great way of putting it," I told Dave. "When your entire financial future is at stake, what would you rather have on your side – a confident but unreliable 'gut feel' for the market, or a rules-based model, like your instrument panel, with a long track record of success?"

Beyond investing

I had finished my run by then, so I got off the treadmill and left Dave to mull over what we'd been talking about. I could see I had got him thinking, but it was hard to know if that was enough to affect how he would make investment decisions in the future. I hoped it would.

I also knew that the principles of behavioral finance extend beyond investing to other areas of our financial lives. It has huge effects on our spending, saving, our borrowing and how we manage risks in our lives. And in all these areas, knowing is one thing, doing is another. The approach I was advocating was truly simple, but it was by no means easy.

I have been doing my investing and financial planning like this for years, since before behavioral finance was even known as such. But I still find it hard to resist the market's many temptations. Our ingrained behavioural factors are so powerful and so pervasive that it is often very, very hard not to be influenced by them. But the rewards, the stability, and the peace of mind that go with resisting them truly make the effort worthwhile.

The Stan Clark Financial Team at CIBC Wood Gundy is a wealth management group specializing in organizing, protecting and growing wealth for professionals, business owners, retirees and their families. Our services integrate financial planning and investment management. Based on the principles of behavioral finance, our disciplined, rules-based approach combines proprietary investment strategies and leading-edge technology. The goal is to manage your wealth, providing you with more time and money to enjoy life to the fullest.

For more information...

To learn more about CIBC Wood Gundy, Stan Clark, the Stan Clark Financial Team and the many ways we can help manage your wealth, please call (604) 641-4361 or toll free at 1 (800) 661-9442.

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