



Behaving Badly!

“BeFi; controlling those inner urges”

Richard Harris

Speech to the CFA Institute, India Societies

Pune. 1st May 2015



PORT SHELTER
INVESTMENT MANAGEMENT

Richard Harris

| INVESTMENT STRATEGY | EXPERT WITNESS |

INVESTMENT

- *37 years experience, Asia, Europe, US.*
- *Managed large pension, mutual and private funds for global firms*
- *For sovereigns, institutions, families, private clients.*
- *Coined the terms, “Li-onomics”, “Ramper Tantrums”.*
- *Writer and Broadcaster on investment and global financial matters*
- *Guest lecturer on Behavioural Finance for the CFA Institute*



EXPERT

- *Independent Financial Expert Witness for legal cases*
- *Experienced in all market misconduct, client/institution disputes, shareholder, credit cases et al.*
- *Includes complex derivative cases; as well as calculating amounts of damages for the Courts.*
- *Harvard MBA. Chartered Engineer. King’s BSc, Imperial MSc. Peking, Stanford Universities (cert.)*



What is Behavioural Finance?

Combines psychology and finance

Emotions systematically affect investment decisions...
... explain unusual market movements or inefficiencies

It's not new!

Adam Smith – 'Invisible hand of the market, 1776'

John Maynard Keynes – 'animal spirits'

Daniel Kahneman - biases

Nicholas Taleb – discontinuities, outliers



Understanding the Financial Markets *Bird and Fortune*



https://www.youtube.com/watch?v=mzJmTCYmo9g&feature=em-share_video_user

Take rational financial analysis:

- **Fundamentals**
 - Geopolitics
 - macroeconomic trends (growth vs. cyclicals)
 - announcements of economic results (against trend, forecasts)
 - announcements of company results (ditto)
- **Valuation**
- **Liquidity**
- **Technical analysis - charts** (behavioural)
- **Inferences** (from the press)



Consolidate it with:

Asset Allocation, Investment Selection, Portfolio Construction, Risk Analysis

Then add a little Behavioural Psychology:

***Nobel Prize Economics 2002: Kahneman;
2013: Fama, Hansen & Schiller***

Thinking Fast and Slow: Kahneman

Instinctive, emotional, internal

What a person thinks and believes; family, upbringing, values; (doc man & nurse)

Analytical, cognitive, external, thinking

Processing information

(cognitive dissonance, what makes smart people stupid). Ulric Neisser

lead to BEHAVIOURAL BIAS



Asian Investors like:

- Fast decisions
- Don't like to lose face
- "News dominated"
- Not trusting – don't like advice
- Then too trusting (bec. detail lazy)

Makes investors very susceptible to BEHAVIOURAL BIAS



Source: Barclays.

less intense <

Primary Emotion

> more intense

Interest	Anticipation	Vigilance
Serenity	Joy	Ecstasy
Acceptance	Trust	Admiration
Apprehension	Fear	Terror
Distraction	Surprise	Amazement
Pensiveness	Sadness	Grief
Boredom	Disgust	Loathing
Annoyance	Anger	Rage

Source: MK Lai, HKSI

Emotions and Decision Making

– how we process information (heuristics)

GREED vs FEAR

SENTIMENT vs REASON

BOOM vs BUST

AGGRESSION vs APPREHENSION

PRIDE vs REGRET



behaviorgap.com Carl Richards



market is no more than 5 - 7 years old

Greed and Fear ...

BELIEVE ME SIR,
IF I COULD AFFORD TO,
I'D BUY TWO OF THESE



Boo

EMOTIONAL

THINKING

A bat and ball cost \$1.10

The bat costs one dollar more than the ball.

How much does the ball cost?

If ball costs 10c, the total cost is \$1.20

(10c ball; \$1.10 bat)

... correct answer is 5 cents



EMOTIONAL

THINKING

Human perceptions not precise

- **assigning probabilities** (1:10 vs. 1:1000)
- **mental accounting** (what is \$1 worth?)
(sunk cost)

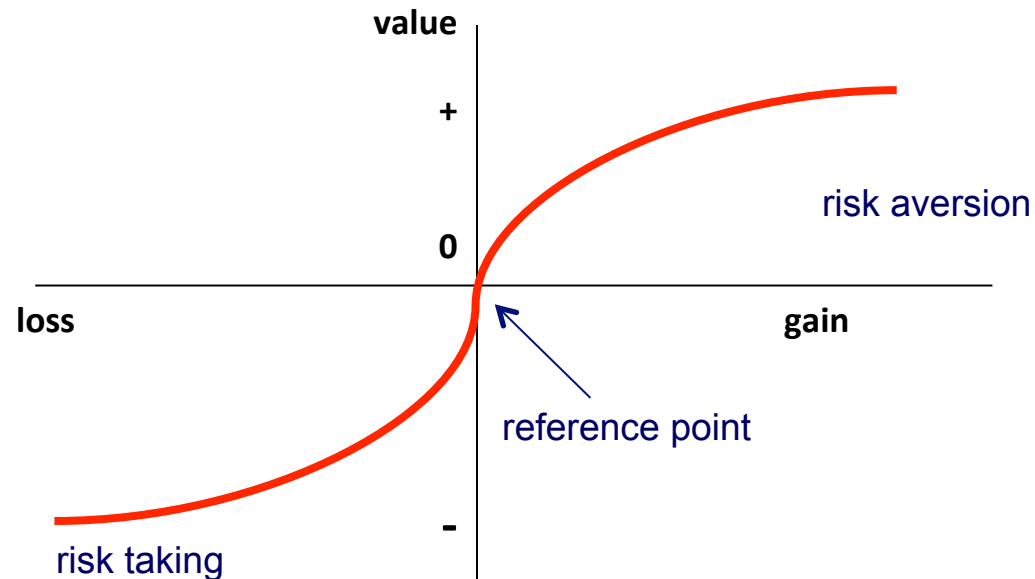
perceptions of the situation (reality check)

Perceptions come from where you sit

EMOTIONAL

THINKING

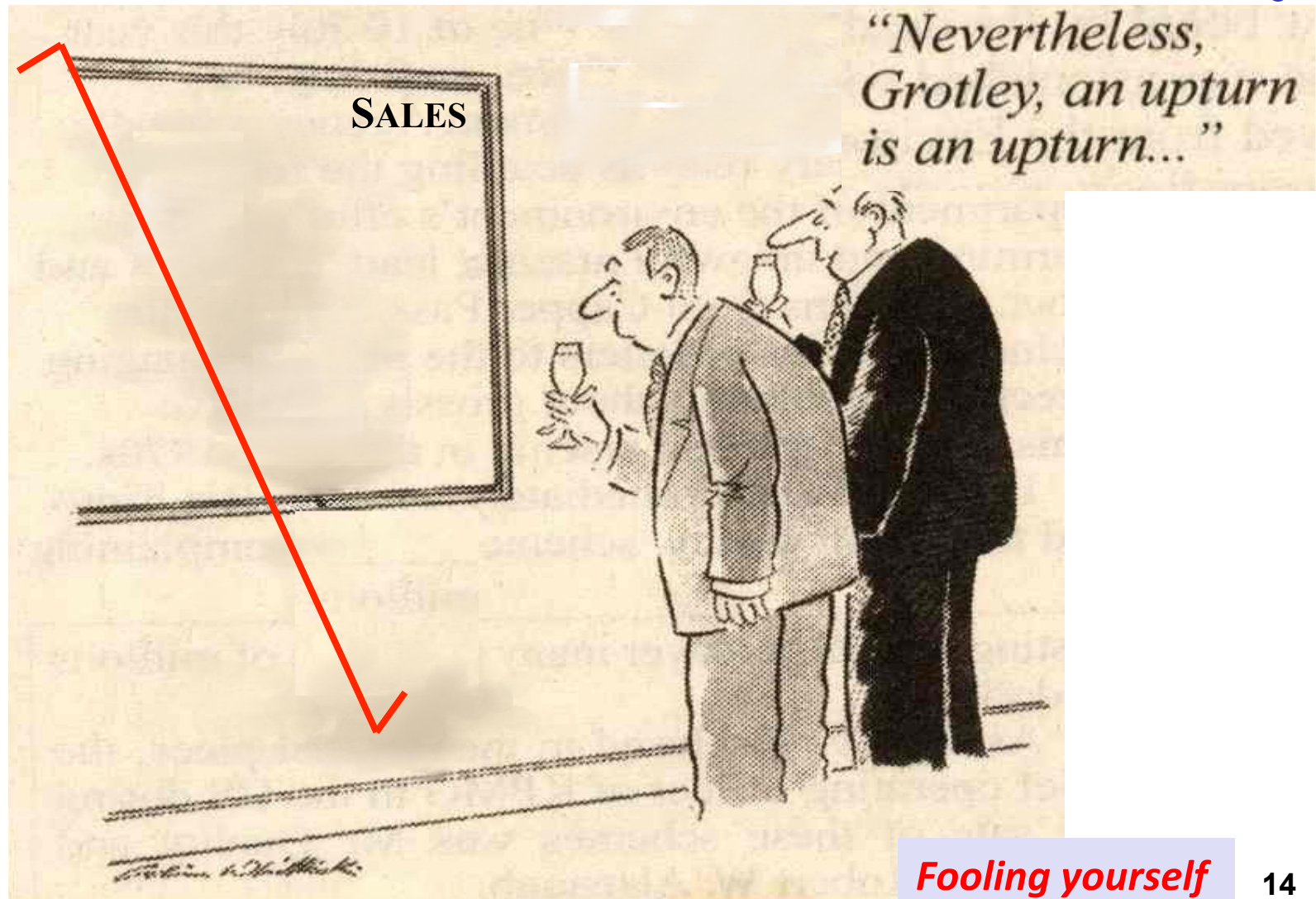
Prospect Theory attitude to risk / return



“control the urges that get people into trouble” *Warren Buffet*



The Money Illusion



Fooling yourself



Experts

Finance Sections of Newspaper

Email and SMS

CNBC, BBC, Bloomberg

INVESTOR

Golf course Chatter

Lobbies and Elevators

Wall Street Research Reports

Behavioural actions related to Newsflow

- Importance of news
- Timing
- Discounting
- Shocks and surprise
- Compound Effects

Analysis:

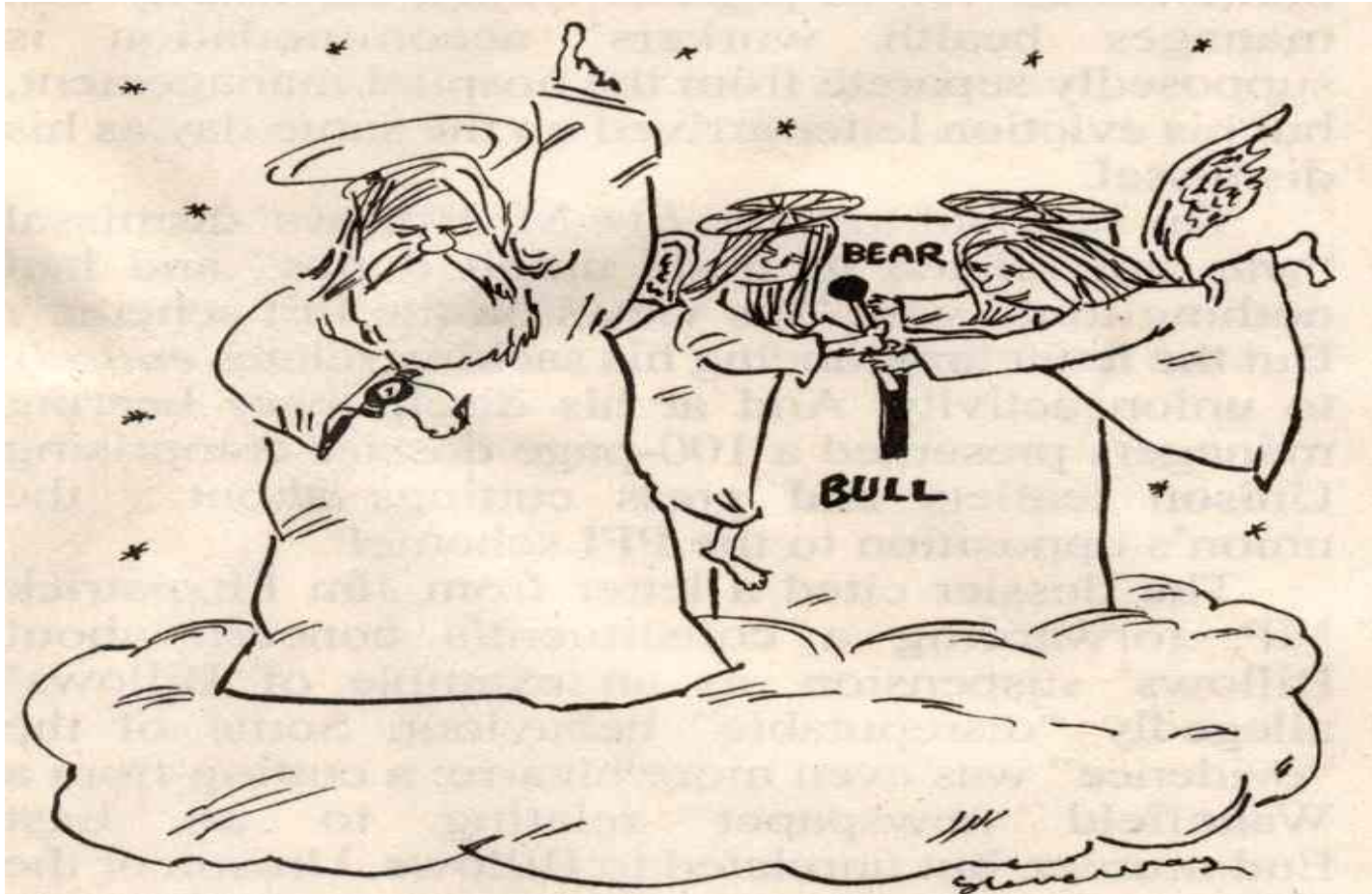
- *known knowns*
- *unknown knowns*
- *unknown unknowns*

NEWS and DISCOUNTING

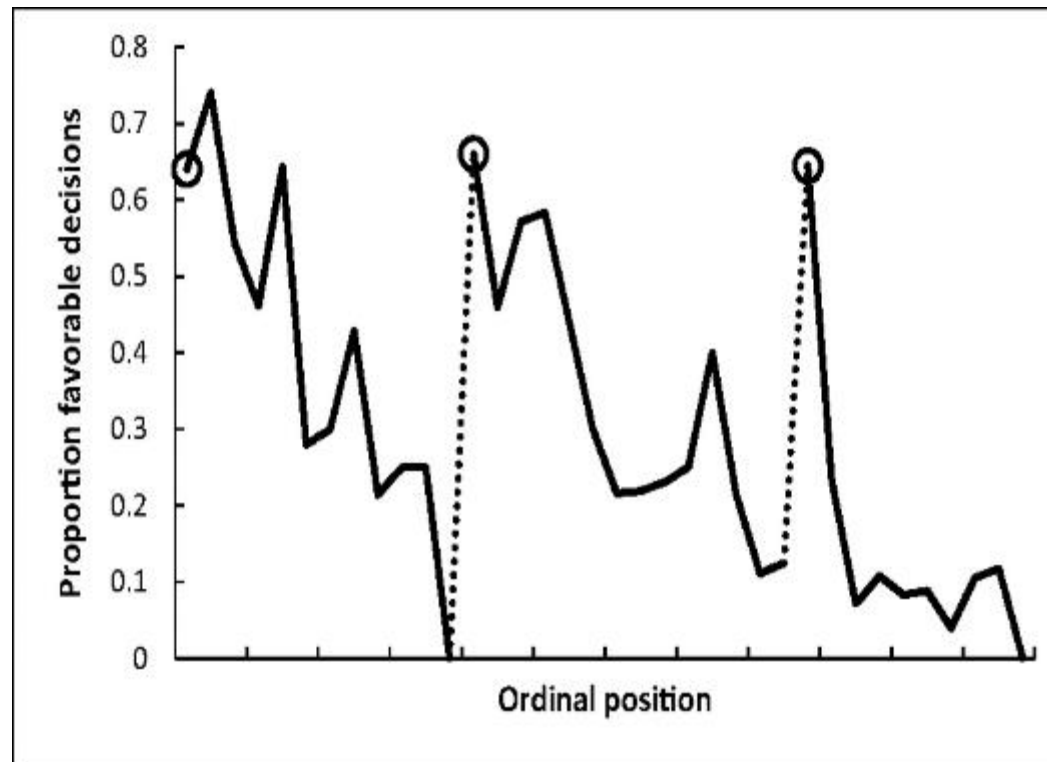


Unpredictable

"I have never met a person who could forecast the market" Warren Buffet



Judicial rulings in favour of parole for prisoners by order in the day (dotted lines are food or drink breaks)



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THINKING

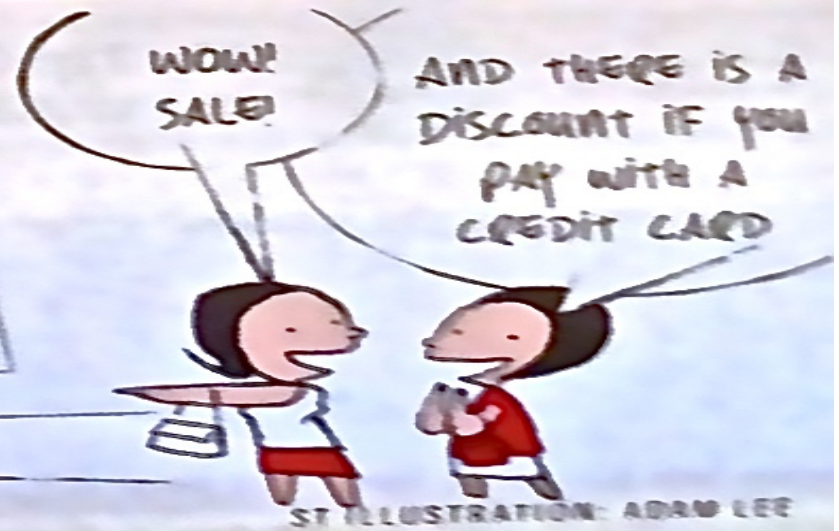
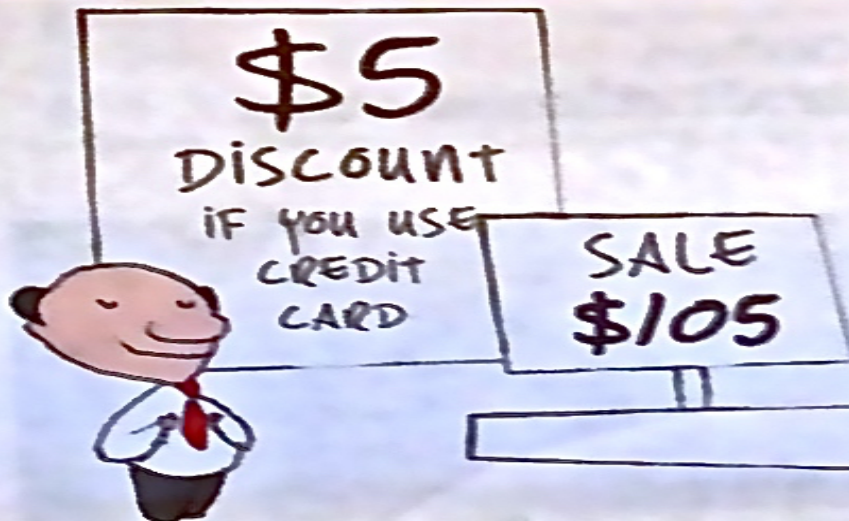
ANCHORING

- mistaken reference points
- losing **perception**
- WhatsApp sale





PUNCHLINES





EMOTIONAL

THINKING

PRIMING

- **setting the scene** (accident descriptions)
- **misdirected attention** (YouTube “invisible gorilla”)



Ban DHMO !

Di-hydrogen monoxide:

- a major component of acid rain
- can cause severe burns
- is fatal if inhaled.
- accelerates corrosion
- used as an additive in "junk-food"
- as an industrial solvent
- in the production of Styrofoam
- in animal research
- reduces the effectiveness of car brakes
- found in tumors of terminal cancer patients



Warning! Dangerous Contamination



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FRAMING

- how data is **presented**
- **leads to skewed assumptions**
- e.g. **decoy**



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- **overconfidence**– “*d@mn, I’m good*”
- **think you can beat the market** - what can go wrong?
- **Attitude bias** - stubborn (pride and regret; cut winners run losers)
- **Can you trust the experts?** (Gawande)

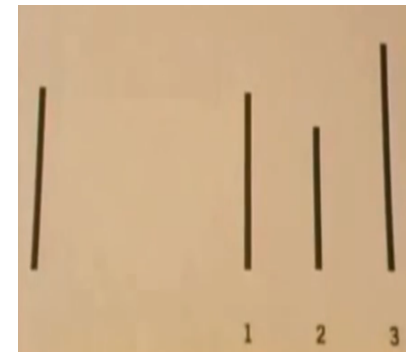
confidence => traders curse or blessing

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THINKING

- **Compliance bias** (cognitive dissonance) (*Asch experiment*)
- **obedience to authority** (LIBOR)
- **overfocus** beating index, sector blindness
ST vs. LT, focus single loss maker

You Tube: Asch experiment, 1951



Fear of failure

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THINKING

Momentum in markets

The First Follower



<https://www.youtube.com/watch?v=fW8amMCVAJQ>

Derek Sivers (2010)



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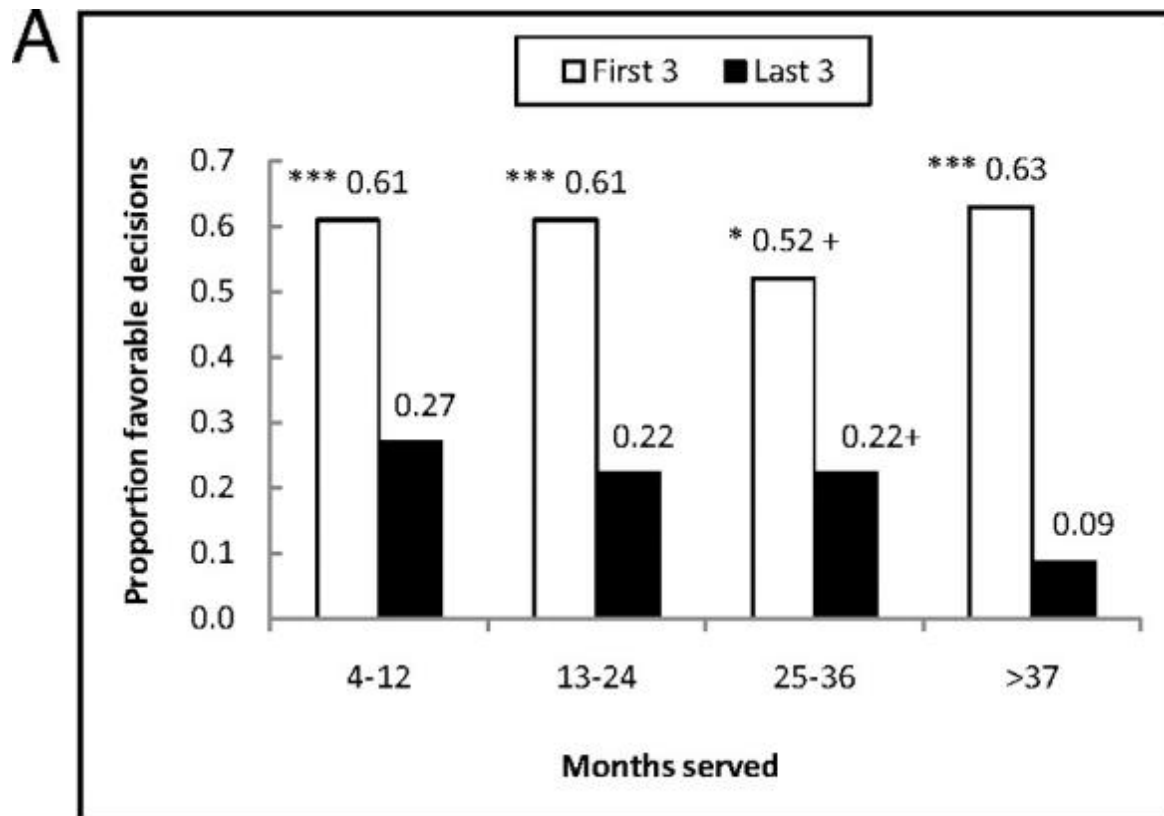
- **status quo** (too much info, no decision, '*paralysis by analysis*')
• **Familiarity bias** (fear uncertainty, sector blindness)
• **Availability bias** (comes to mind)
• **Repetition bias** (repeated suggestions, twice is right)

Comfortable Safe

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THINKING

Favourable parole decisions as a function of order of review, months served, and previous incarcerations.





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REPRESENTATIVE BIAS

- develop stereotypes / mantras
- Hindsight bias

CONFIRMATION BIAS

- use data to **confirm preconceived ideas** (flying incidents)





Analysts being wrong

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THINKING

PATTERN RECOGNITION

noise, trend, spurious correlations, January effect, Nifty Fifty

Analysts. ... Behaving Badly!





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THINKING

SPURIOUS CORRELATIONS

- reporting and distribution of **incorrect information**
- **Selective** memory

bias



Common Market Biases

Feature	Indicator	Bias	Mistake	Consequence	Remedy
Pride & Regret	stubborn	<i>Prospect Emotional Disposition</i>	lose judgement, wrong decisions	take profits, hold losers	run winners, cut losers
Overconfidence	no fear of failure	<i>Expert</i>	think you can beat the market	trade too actively, not enough research. Whiplashed timing	modesty, think what can go wrong,
Anchoring	using particular benchmark?	<i>Confirmation Framing Priming</i>	mistaken reference points, bad assumptions	loss of perspective	use strategic / tactical tools
Herd Instinct	fear of failure	<i>Compliance Home Familiarity</i>	safety in numbers, stick with the pack	mediocre performance	sometimes have to suspend disbelief
Recency	overemphasise latest information	<i>Attention Hindsight</i>	make decisions on most recent events	get whiplashed, short term trap	look longer term, analyse, relax
Availability	comfortable, lazy	<i>Home Repetition</i>	status quo, no decisions at all or easily swayed	market moves away (principle of continuous revolution)	don't get comfortable, think.
Stereotypes	complexity is over-simplified	<i>Representativeness Confirmation</i>	complacency	fail to diversify	diversify
Mistaken assumptions	instinctive, don't stop to think	<i>Expert</i>	spurious correlations	judgement issue, misjudge investment, <i>plus ca change ...</i>	trust your training, use investment tools

what BIASES are your weakness?

1. **be aware** of your own biases; *unreliability*
2. **question assumptions**
3. **challenge entrenched** perceptions and mantras
4. **avoid anchoring**; be prepared to adjust reference points
5. **Listen** to other analysts to offset pattern recognition / confirmation bias
6. **recency**: *what happened six months / a year ago ?!*
7. is news discounted? – “*known unknowns*”
8. think big, outside the box.

Ask Questions Analyse yourself Listen

Daniel Kahneman – *Thinking Fast and Slow*

- *Intuitive or Reasoning*
- *Need to know what we are good at*



Freakonomics:

Undercover Economist:

Blink, Tipping Point, Outliers, Dog Saw:

Nudge:

Predictably Irrational:

Irrational Exuberance

Hour between Dog and Wolf:

Collapse:

Complications:

Black Swan, Antifragile:

Levitt & Dubner (market decisions)

Hartford (street observations)

Gladwell (intuition, exceptions)

Thaler and Sunstein (political behaviour)

Ariely (why we are not rational)

Schiller

Coates (aggression/apprehension)

Diamond (the end game)

Gawande (surgery)

Taleb (discontinuities)

Anything on GFC: Paulson, Geithner, Lewis, Ross Sorkin

Thank You

Questions on Behaving Correctly

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Prices and Newsflow - macro

MSCI World 1970 - 2014



2018?



Prices and Newsflow - micro

Occupy Central Sept/Oct 2014

