Behaving Badly!

“BeFi; controlling those inner urges”

Richard Harris

Speech to the CFA Institute, India Societies
Pune. 1st May 2015
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=mZjmTLYmo9g&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*
Instinctive vs. Analytical

*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*
Investing by Emotion not Analysis

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
Emotions and Decision Making

– how we process information (heuristics)

- GREED vs FEAR
- SENTIMENT vs REASON
- BOOM vs BUST
- AGGRESSION vs APPREHENSION
- PRIDE vs REGRET

market is no more than 5 - 7 years old
BELIEVE ME SIR, IF I COULD AFFORD TO, I’D BUY TWO OF THESE
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
Mental Perceptions

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)
Prospect Theory
attitude to risk / return

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

“Nevertheless, Grotley, an upturn is an upturn...”

Fooling yourself
INVESTOR

Experts

Finance Sections of Newspaper

Email and SMS

CNBC, BBC, Bloomberg

Golf course Chatter

Lobbies and Elevators

Wall Street Research Reports

Behaviour and News
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
“I have never met a person who could forecast the market” Warren Buffet
We are all Biased

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

ANCHORING

- mistaken reference points
- losing perception
- WhatsApp sale
PUNCHLINES

I'm not buying since there is a 5% credit card surcharge!

$100

$5 discount if you use credit card

$105

Sale

WOW! Sale!

And there is a discount if you pay with a credit card.
Mind Games

PRIMING

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

FRAMING

• how data is presented
• leads to skewed assumptions
• e.g. decoy
Mind Games

<table>
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<th>THINKING</th>
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Mind Games

EMOTIONAL

THINKING

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Expert Bias

- **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
Herd Instinct

- Compliance bias (cognitive dissonance) \textit{(Asch experiment)}
- Obedience to authority \textit{(LIBOR)}
- Overfocus beating index, sector blindness
  ST vs. LT, focus single loss maker

You Tube: Asch experiment, 1951

Fear of failure
Momentum in markets

The First Follower

Derek Sivers (2010)

https://www.youtube.com/watch?v=fW8amMCVAJQ
Home Bias

<table>
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<tr>
<td>• status quo</td>
<td>(too much info, no decision, ‘paralysis by analysis’)</td>
</tr>
<tr>
<td>• Familiarity bias</td>
<td>(fear uncertainty, sector blindness)</td>
</tr>
<tr>
<td>• Availability bias</td>
<td>(comes to mind)</td>
</tr>
<tr>
<td>• Repetition bias</td>
<td>(repeated suggestions, twice is right)</td>
</tr>
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Comfortable  Safe
Recency / Primacy Bias

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

Simplification

**REPRESENTATIVE BIAS**

- develop stereotypes / mantras
- Hindsight bias

**CONFIRMATION BIAS**

- use data to confirm preconceived ideas
  (flying incidents)
Analysts ..... being wrong

PATTERN RECOGNITION

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

Analysts. ... Behaving Badly!
Pattern Recognition
…..from wrong assumptions

SPURIOUS CORRELATIONS

• reporting and distribution of **incorrect information**

• **Selective** memory

**bias**
# Common Market Biases

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

**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*
Recent Theory on Thinking

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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Occupy Central Sept/Oct 2014

HK stock prices

HK volatility

HKD:USD

tear gas

market opens after holiday