INVESTMENT PSYCHOLOGY – BEHAVIOR AND BIASES

"The investor's chief problem—and even his worst enemy—is likely to be himself." – Benjamin Graham

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Topic: Interest Rate Trends and Implications

Hans Dijs

Marathon Investments, LLC

hansdijs@aol.com   (203) 984-4534

Reaching financial success is a marathon, not a sprint.

Slow and steady wins the race.

Just a normal day at the nations most important financial institution

BEHAVIORAL FINANCE

- Behavioral finance proposes psychology-based theories to explain stock market anomalies,
- Behavioral Finance is the study of the influence of psychology on the behavior of investors..
- It also includes the effects on the markets, such as severe rises or falls in stock price
- It focuses on the fact that investors are not always rational, have limits to their self-control, and are influenced by their own biases.

EFFICIENT MARKET HYPOTHESIS (EMH)

- The efficient market hypothetis (EMH) proposes that at any given time in a liquid market, or where there are plentiful buyers and sellers, prices reflect all available information.
- Many traditional models are based on the belief that market participants always act in a rational and wealth-maximizing manner.
- Behavioral finance contradicts the EMH by studying different psychological biases that humans possess. These biases lead to irrational investment decisions.

BELIEFS OF TRADITIONAL FINANCE

- Both the market and investors are perfectly rational
- Investors care about utilitarian characteristics. Actions are right insofar as they promote happiness for everyone
- Investors have perfect self-control
- Investors are not confused by cognitive errors or information processing errors

TRAITS OF BEHAVIORAL FINANCE

- Investors are treated as “normal” not “rational”
- They actually have limits to their self-control
- Investors are influenced by their own biases
- Investors make cognitive errors that can lead to wrong decisions

TWO TYPES OF EMOTIONAL REACTIONS

- Investors who allow their emotions to dictate their investment decisions will suffer from poor long-term results.
- Fear of Missing Out (FOMO). These investors will chase stocks that appear to be doing well, for fear of missing out on making money. This leads to speculation without regard for the underlying investment strategy.
- Fear of Losing Everything (FOLE). A more powerful emotion comes from the fear that they will lose all of their investment.
- When market volatility causes large swings in the stock market, people can become unnerved, causing them to sell their investments. This behavior was most prevalent in the wake of the 2008 financial crisis and they missed the following recovery.

No investor in the history of stock markets has batted 1.000 when investing.

- General rule of thumb: avoid emotional decision-making,
- Investors should also not chase speculative "get-rich-quick" fads. Diversifying a portfolio mitigates downside risk.
- Have a sound investment strategy based on objective metrics rather than speculation.
- Holding to a strategy will guide an investor during periods of volatility, helping to resist the urge to panic sell during a correction or chase a hyped-up stock trading at unsustainable levels.
- Patience is critical, and investors who remind themselves of why they invested in the first place will better keep their emotions in check.

You don’t need to have a high IQ to be successful

- Successful investing does not require a high IQ, but it requires the ability to identify and overcome one's own psychological weaknesses.
- The investor’s chief problem—and even his worst enemy—is likely to be himself. – Benjamin Graham
- Insights from the field of behavioral finance can benefit individual investors.
- Human psychology is a dangerous thing, and there are some standard mistakes that people make again and again. It is very easy in the heat of the moment, or when subject to stress or temptation, to fall into one of these mind traps.

We can break down the decision-making biases and errors into at least four buckets.

- Self-deception - The concept of self-deception is a limit to the way we learn. When we mistakenly think we know more than we actually do, we tend to miss information that we need to make an informed decision.
- Heuristic simplification refers to information-processing errors.
- Emotion in behavioral finance refers to our making decisions based on our current emotional state. Our current mood may take our decision making off track from rational thinking.
- Social influence - is how our decision making is influenced by others.

THE OVERCONFIDENCE BIAS

- The overconfidence bias refers to our thinking that we're smarter or more capable than we really are.
- For some people, this superiority trap is dangerous; they think they know better than the experts or even the market.
- Studies show that overconfident investors trade more rapidly because they think they know more than the person on the other side of the trade.
- Overconfident investors believe they have more control over their investments than they truly do.
- They have the habit of attributing favorable outcomes to expertise and unfavorable outcomes to bad luck, or an exogenous event, dismissing their own contribution.
- George Soros is known to account for this tendency by keeping a journal log of his reasoning behind every investment decision

Selective memory bias

- Few of us want to remember a painful event or experience in the past, particularly one that was of our own doing.
- In terms of investments, we certainly don't want to remember those stocks that we missed (had I only bought Apple (AAPL) in 2005) much less those that proved to be mistakes that ended in losses.

Herding Bias

- The herd instinct leads people to follow popular trends without any deep thought of their own.
- Herd behavior states that people tend to mimic the financial behaviors of the majority or the herd.
- Herding is notorious in the stock market as the cause behind dramatic rallies and sell-offs.
- The herd instinct is correlated closely with the empathy gap, which is an inability to make rational decisions under emotional strains, such as anxiety, anger, or excitement.
- We are hard-wired to herd. Going against the crowd / non-conformity triggers fear in people.
- Any temporary comfort derived from investing with the crowd or following a market guru can lead to fading performance or inappropriate investments for your particular goals.

The Anchoring Bias

- The anchoring bias refers to an over-reliance on what one originally thinks.
- For instance, if you think of a certain company as successful, you may be too confident that its stocks are a good bet.
- This preconception may be incorrect now or at some point in the future.
- In order to avoid this trap, you need to remain flexible in your thinking and open to new sources of information, while understanding the reality that any company can be here today and gone tomorrow.
- Example: Radioshack a thriving electronics retailer in the 80s and 90s.
- When an investment is lagging, we may hold on to it because we cling to the price we paid for it, or its strong performance just before its decline.
- In an effort to "break even" or get back to what we paid for it, we may cling to subpar companies for years, rather than dumping them and getting on with our investment life.

Confirmation Bias

- Confirmation bias is when investors have a bias to accepting information that confirms their already-held belief in an investment.
- If information surfaces, investors accept it to confirm that they're correct about their investment decision—even if the information is flawed.
- Our natural tendency is to listen to people who agree with us. It feels good to hear our own opinions reflected back to us.

Loss Aversion

- We tend to feel the pain of a loss two times more strongly than we do the pleasure of a gain.
- Investors tend to obsessively focus on one investment that's losing money, even if the rest of their portfolio is in the black. This behavior is called loss aversion.
- Investors are more likely to sell winning stocks in an effort to "take some profits," while at the same time not wanting to accept defeat in the case of the losers.
- Philip Fisher wrote in his book *Common Stocks and Uncommon Profits* that, "More money has probably been lost by investors holding a stock they really did not want until they could 'at least come out even' than from any other single reason."
- Regret also comes into play with loss aversion. It may lead us to be unable to distinguish between a bad decision and a bad outcome. We regret a bad outcome, such as a stretch of weak performance from a given stock, even if we chose the investment for all the right reasons. In this case, regret can lead us to make a bad sell decision, such as selling a solid company at a bottom instead of buying more.

Sunk Costs

- Another factor driving loss aversion is the sunk cost fallacy. This theory states that we are unable to ignore the "sunk costs" of a decision, even when those costs are unlikely to be recovered.
- One example of this would be if we purchased expensive theater tickets only to learn prior to attending the performance that the play was terrible. Since we paid for the tickets already, we would be likely to attend the play.
- Sunk costs may also prompt us to hold on to a stock even as the underlying business falters, rather than cutting our losses.
- It is truly hard to take a loss and/or accept that you made the wrong choices. But if your investment is no good, or sinking fast, the sooner you get out of it and into something more promising, the better.
- Emotional commitment to bad investments just makes things worse.

The Familiarity Bias

- The familiarity bias is when investors tend to invest in what they know, such as domestic companies or local investments.
- As a result, investors are not diversified across multiple sectors and types of investments, which reduces risk. Investors tend to go with investments that they have a history with or have familiarity.
- Beyond a geographic familiarity bias, investors also exhibit strong preferences for investing in their employer’s stock.
- This can be dangerous for employees because, if employees devote a large portion of their portfolios to their own company’s shares, they risk compounding losses if the company performs poorly: first, in loss of compensation and job security, and second, in loss of retirement savings.

Framing Bias

- Judging information by how it was presented (framed) rather than at face value.
- Stories govern the way we think. We will abandon evidence in favor of a good story.
- Admired stocks often come with great stories and high prices.

The Relativity Trap

- Everyone has a different psychological make-up, combined with a unique set of circumstances extending to work, family, career prospects and likely inheritances.
- This means that although you need to be aware of what others are doing and saying, their situation and views are not necessarily relevant for you.
- You must invest for yourself and only in your own context.
- Your friends may have both the money and the risk-tolerance to speculate in pork belly futures (as in the movie "Trading Places"), but if you are a modest earning and nervous person, this is not for you.

The Exuberance Bias

- When investors start believing that the past equals the future, they are acting as if there is no uncertainty in the market.
- Unfortunately, uncertainty never vanishes. There will always be ups and downs, overheated stocks, bubbles, industry-wide losses, panic selling in Asia and other unexpected events.
- When enough investors are overconfident, we have the conditions that investors pump up the market to the point where a huge correction is inevitable.
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House Money Effect

- This is a gambling term but does have relevance in the world of investment.
- People in a casino are more likely to bet recklessly with money they have recently won than money they brought into the casino.
- In stock market terms, this means if an investor has a good run with some investments, he may be tempted to take on a higher level of risk with future investments

It is a “he-said, Xi-said market.”

- The twists and turns of the trade fight is keeping everybody on edge.
- August 23 - Trump said he’s ordering American companies to immediately start looking for an alternative to China.
- Then the U.S. and China agreed to new trade talks in October in a sign of cooling trade tensions.
- The market assumes some sort of a trade deal with China in the next six to nine months.
- Last week, the 10-year Treasury yield rose from 1.46% on Sept. 3 to 1.89% on Sept. 13.
- Before last week investors were betting that bond yields would continue to fall. Both momentum and low volatility (‘bond-like’) stocks rose as yields fall.
- What created this problem was fear of an impending slowdown and a search for safety.
- Last week, the market’s best performers (momentum stocks and low-volatility stocks) declined in favor of value stocks and small cap.
- A failure of trade discussions, could unwind the recent moves.

List of worries

- Bond market – inverted yield curve – the yield on the benchmark 10-year Treasury note has fallen below the 2-year yield several times since August 14.
- Federal Government deficit topped $1 trillion for the 11 months of fiscal 2019. This is equal to more than 4% of GDP.
- GDP in the U.S. is slowing. The economy expanded by 2% in the second quarter.
- Earnings growth is slowing, expected to be up only 2.3% this year. Difficult compare though as 2018 was very strong as a result of the corporate tax cut.
- U.S. manufacturing growth slowed to the lowest level in almost 10 years; the PMI (purchasing managers' index) was 49.9 in August. Any reading below 50 signals contraction.
- Copper, known as a barometer of economic health, is down over 13% in the last half year.
- Gold prices have soared more than 20% since May. Gold is known as a safe haven trade in times of economic uncertainty.
- Global economic policy uncertainty index – at all time high.
- Business spending declined 5.5% in Q2.
- Positive: Consumer spending, which accounts for upward of 70% of the U.S. economy, remains robust. That reflects the strong employment situation

Weightings S&P 500 as of 8/30/19 www.sectorspdrs.com

- Technology (XLK): 22.1% - MSFT, AAPL, V, MA, INTC
- Health Care (XLV): 13.9% - JNJ, MRK, UNH, PFE, ABT
- Financials (XLF): 12.8% - BRKb, JPM, BAC, WFC, C
- Communication Services (XLC): 10.5% - GOOGL, FB, ATVI, T, CMCSA
- Consumer Discretionary (XLY): 10.2% - AMZN, HD, MCD, SBUX, NKE
- Industrials (XLI): 9.2% - BA, HON, UNP, UTX, LMT

Weightings S&P 500 as of 8/30/19

- Consumer Staples (XLP): 7.6% - PG, KO, PEP, WMT, COST
- Energy (XLE): 4.4% – XOM, CVX, COP, SLB, EOG
- Utilities (XLU): 3.5% - NEE, DUK, D, SO, EXC
- Real Estate (XLRE): 3.3% - AMT, CCI, PLD, EQIX, SPG
- Materials (XLB): 2.7% - Linde, ECL, DD, APD, SHW