



On your best behaviour – 20th March 2009

Investors are strange creatures: they wait until the market has risen before they put money in and then sell out when the market has plunged - or worse, hold on to a floundering stock, waiting for it to get back to the value they paid for it.

Why do we behave irrationally? We would not wait for the price of our morning coffee to go up 20% before buying it, so why do we do this with investments? Why do we panic when markets drop, even though we knew it would happen? And why do we become attached to lame ducks when selling them and moving on would get our money back quicker?

Many theories abound: go back as far as the 18th century and economists such as Adam Smith were seeking an explanation of why markets behave as they do. One that has gathered force of late is behavioural finance.

Behavioural finance suggests people often make decisions based on so-called rules of thumb, rather than after rational analysis. Technically referred to as heuristics, it involves understanding that the way a problem is presented can affect the outcome (a process called framing). Therefore, market inefficiencies are not the only way to explain outcomes that go against rational expectation.

Two of the most influential psychologists in the field are Daniel Kahneman and Amos Tversky who, in 1979, published a paper comparing models of rational economic behaviour with decision-making during times of risk and uncertainty. Their theories sought to explain anomalies in the way investors and financial markets react.

These theories help explain how we all got pulled into phenomena such as the technology boom (mostly too late to make any real money), despite the irrational theories that tend to support them.

They also help explain why we sell out of a falling market, just when our loss is at its greatest, and why we hold on to 'loved' investments long after they have started to go wrong. And it is why we shy away from markets that have underperformed, despite indications of great potential.

Increasingly, asset managers are using pricing models to take behavioural biases into account, as they believe it gives them an advantage. If you understand these theories, you could have that advantage too. It can be difficult to swim against the tide but, in the long term, you may be very glad you did.