

Behavioral Finance in Practice

10 lessons learned

Society of Investment Analysts in Ireland

Alida Carcano, CFA
Dublin, November 27th 2008



Behavioral Finance in Practice

Economists are people who look at reality, and wonder whether it would work in theory

Ronald Reagan



Behavioral Finance in Practice

Behavioral finance has become an actively debated topic among academics and practitioners.

Unfortunately, it would seem that much of the debate either misses or obviates the extraordinary insights and practical strategies behavioral economics provides the practicing wealth manager.

What is missing from the debate is a recognition that, in spite of its lack of mathematical rigor, the lessons taught by behavioral economics work for those of us dealing with real people

Harold Evensky, The rational wealth manager – March 2008



Behavioral Finance in Practice

This is not a lesson in behavioral finance

It is the attempt to create a framework
to help the wealth manager
in better managing behavioral aspects,
so they do not impair his work
but on the contrary they improve his ability in dealing
with private clients



Be aware of behavioral finance

“Standard Finance” - Investors are rational

Behavioral Finance - Investors are normal

Meier Statman

What wealth managers and their clients need to know about behavioral finance

CFA Institute webcast, 27 March 2007



Normal vs rational

1

Normal investors have:

- thoughts (some of which are wrong)
- emotions (hope, fear, regret ...)

The difference between rational and normal leads to differences in the behavior of investors and markets

Make your client aware of behavioral finance

2

Make examples

Everyday life
(behavioral biases not only in investments)

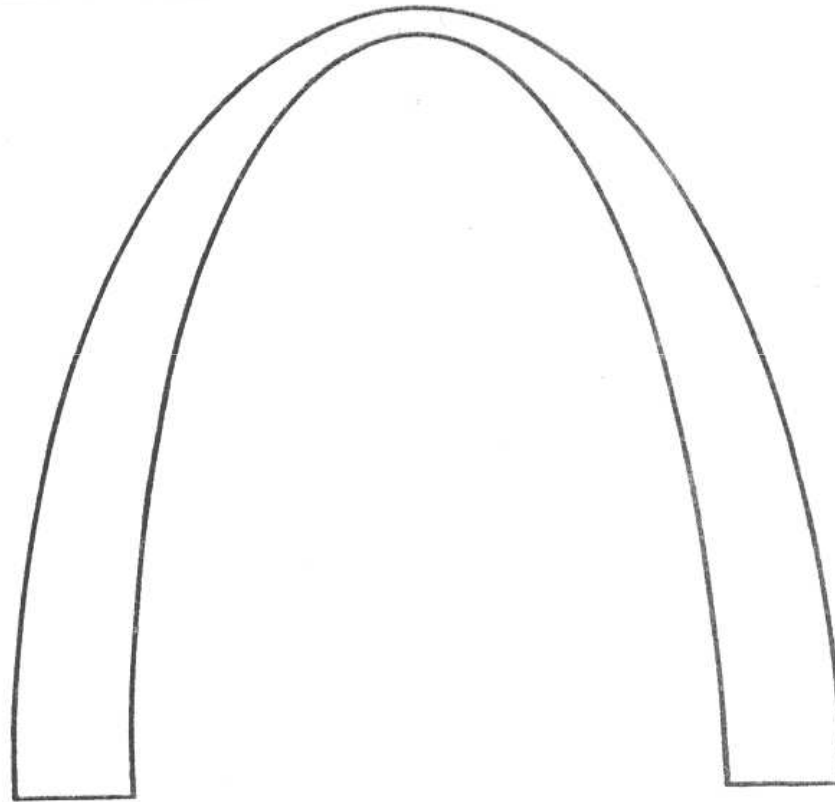
Finance



Example one: St. Louis arch

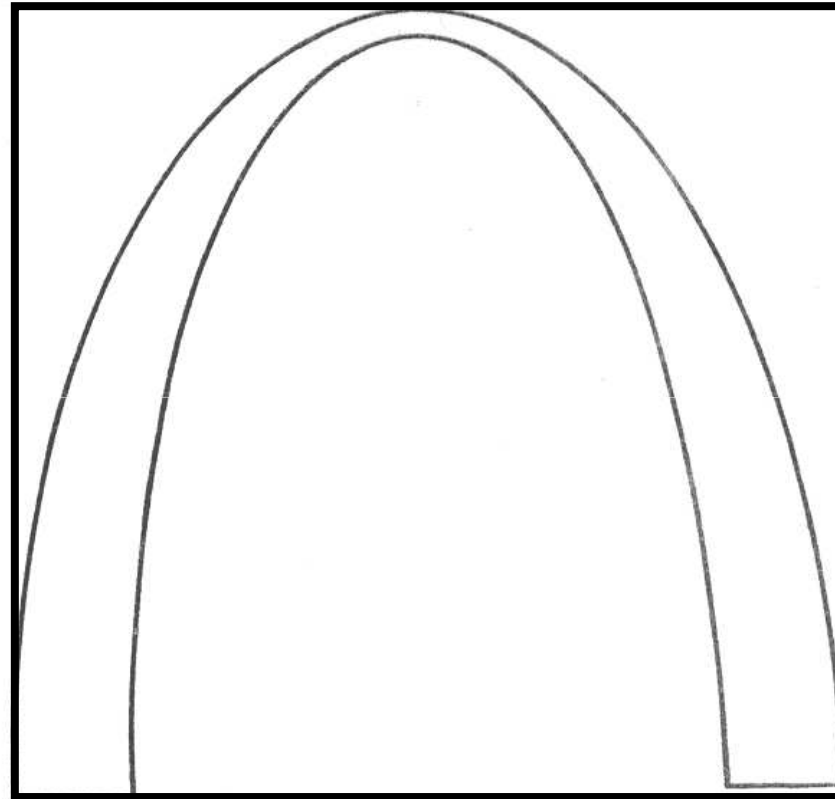
2

Is the St. Louis Arch taller than it is wide?



Example one: St. Louis arch

2



Example two: Linda

2

Linda is 31 years old, single, outspoken, and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and also participated in anti-nuclear demonstrations.

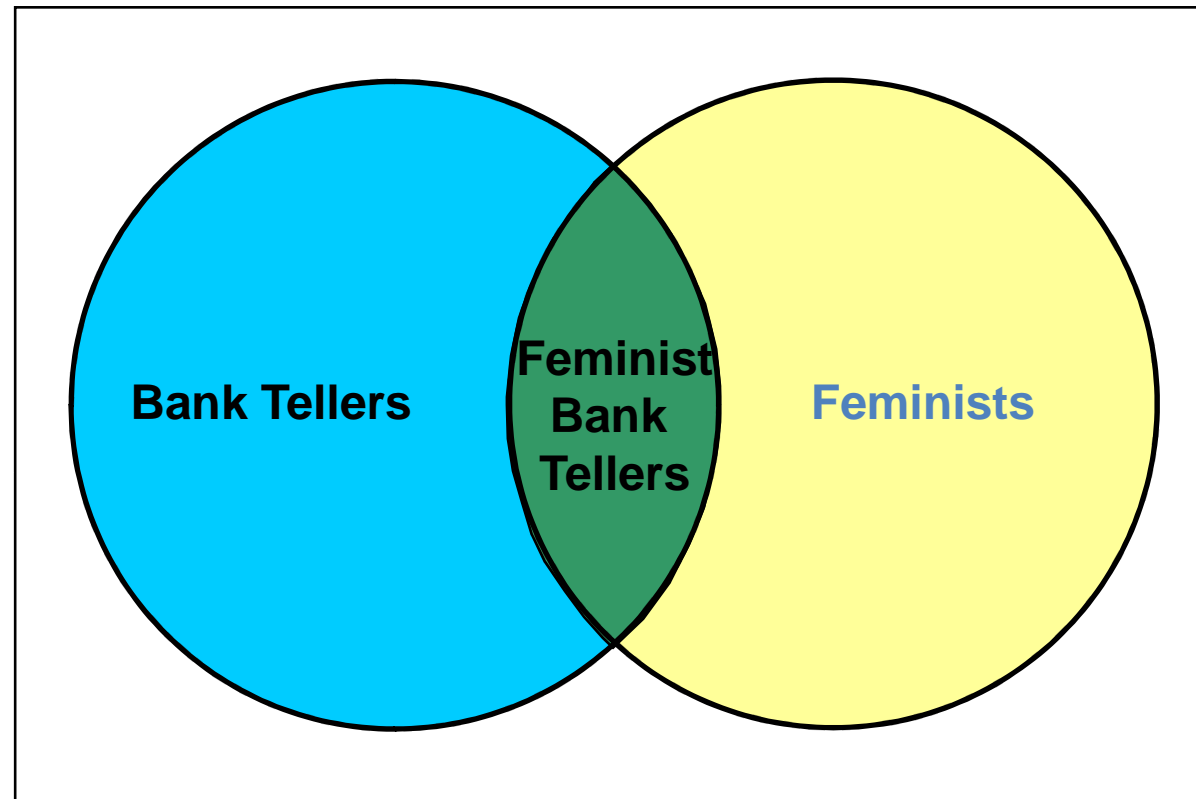
Which event is more probable?

1. Linda is a bank teller.
2. Linda is a bank teller and is active in the feminist movement.



Example two: Linda

2



A. Tversky, D. Kahneman

Extension versus intuitive reasoning: the conjunction fallacy in probability judgment

Psychological review 1983 n. 90 (4)

Example three

A bat and a ball cost \$1.10 in total. The bat costs a dollar more than the ball. How does the ball cost?

If it takes 5 machines 5 minutes to make 5 widgets. How long would it take 100 machines to make 100 widgets?

In a lake, there is a patch of lily pads. Every day, the patch doubles in size. If it takes 48 days for the patch to cover the entire lake, how long would it take for the patch to cover half the lake?

J. Montier
Applied behavioral finance
CFA travelling conference Presentation 2006

Example four

2

$8*7*6*5*4*3*2*1 = \text{median answer } 2'250$

$1*2*3*4*5*6*7*8 = \text{median answer } 512$

Actual answer = 40'320

A. Tversky, D. Kahneman
Judgment under uncertainty: Heuristics and biases
"Science" 1974



Example five

2

Past wealth as a reference point (anchor)

John's wealth increased from \$2 million to \$3 million.

Paul's wealth declined from \$5 million to \$4 million.

Who has more wealth? Who is happier?

D. Kahneman and others

Would you be happier if you were richer? A focusing illusion

"Science" 2006 n. 312



Pick a stock or a bond?

2

Nucleus Accumbens

Center of pleasure in the emotional brain

Food, sex, drugs (cocaine) activate these neurons

Stock (risky): the pleasure of a possible gain overcomes the pain of a possible loss

Insula

Control of (physical) pain in the cortex of the brain

Physical pain, negative emotions activate these neurons

Bond (safe): the pain of a possible loss is too big to bear

(*) B. Knutson, P. Bossaerts
The neural antecedent of financial decisions
"The Journal of neuroscience" 2007 n. 27

R.L. Peterson
Inside the investor's brain. The power of mind over money
Wiley&Sons 2007



Watch out!

2

While talking behavioral finance, you might arise expectations

Clients get enthusiast, expect you to know how to deal with behavioral issues

You are a victim as well

3

Do not forget to tell your client!

Avoid overconfidence

Protect yourself from your own emotions and
cognitive biases

You are a victim as well

Harry Markowitz, Nobel Prize 1990

Interview with “Money” on his pension plan
asset allocation

“I should have calculated covariance for all
asset classes; I should have drawn the
efficient frontier.

But I visualized my pain should the stock
market rise and I was not invested, or decline
and I was invested. So, in order to minimize
my regret, I did 50/50”

BUT you have an advantage

3

YOU

Prepare a policy statement and stick to it

Follow a strategy

Are more disciplined

Review /challenge your policy

Control risks



Do not educate your clients

4

Do not educate, accompany

Do not impose, propose and explain

Do not be arrogant, be humble

Traditional approaches work

5

Do not get caught up

Diversification

Risk control

Policy statement

Asset allocation (strategic and tactical)

Life cycle investing



Traditional approaches work

5

BUT be aware of possible fallacies

Nassim N. Taleb:

Black swan

Average: mediocristan (weight) different from estremistan (wealth)

Learn from the turkey

Nassim N. Taleb
The black swan
2006



Be aware of risk

6

Risk tolerance vs. capacity

Clients usually do not distinguish btw. them

Culture has to do with behavior

7

Know your client

What is an “aggressive” asset allocation?

Do you think in dollars?

Chinese are different from Italians

Meier Statman
Countries and culture in behavioral finance
CFA Institute webcast, 8 April 2008



Listen to your clients



Communication

Listen to the client (goals, dreams, values, but also worries)

Talk his language

Be aware of his finance knowledge

Expect the unexpected



Performe

9

Performance is important

Performance is a relative concept:
is 6% p.a. good or bad?

It depends on risk, expectations, market conditions etc.

and it depends on the client!

Keep learning

10

Dealing with clients is an ongoing learning process

Learn from your client, in every single meeting

Be humble – you do not know it all

Be prepared, make notes



DON'Ts

Forget discipline

Focus on stories (only facts count)

Sell your winners and ride your losers

Think this does not apply to you

Be arrogant, think you know it all

Disregard those who do not agree with you, avoid challenge

Forget that the impossible is actually well possible

Manage your relatives and best friends money



Behavioral Finance in Practice

*The market can stay irrational, longer than you
can stay solvent*

JMK



On the current financial crisis

*Nothing in life is as important as we think it is in
the very moment we think it is*

D. Kahneman

On the current financial crisis: regret

Cognition + emotion

What would have been, if...

Short term effect different from long term

T. Gilovich, V.H. Medvec
The experience of regret: what when and why
Psychological review, 1995 n 102



On the current financial crisis: regret

Regret in everyday life:

Miss the train

Win silver at olympic games

Buy a no brand product

Education, career

NB: the more the alternative choices, the higher the risk of regretting

N.J.Roese, . Summerville

What we regret the most... and why

Personality and Social Psychology Bulletin, 2005 vol 31

V.H.Medvec and others

When less is more: Counterfactual thinking and satisfaction among olympic medal winners

Journal of Personality and Social Psychology, 1995 n 69



On the current financial crisis: regret

Neurobiology of regret

Orbitofrontal cortex: interface btw. deliberate processes and emotions

Invest and regret : In the aftermath, you know (quantitative)

Your regret is my regret - empathy

N. Camille and others

The involvement of the orbitofrontal cortex in the experience of regret

“Science” 2004, 304



Thank you

