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- Paul S. Viren, CLU®, ChFC®, AEP®, designee since 2011, Past President NAEPG

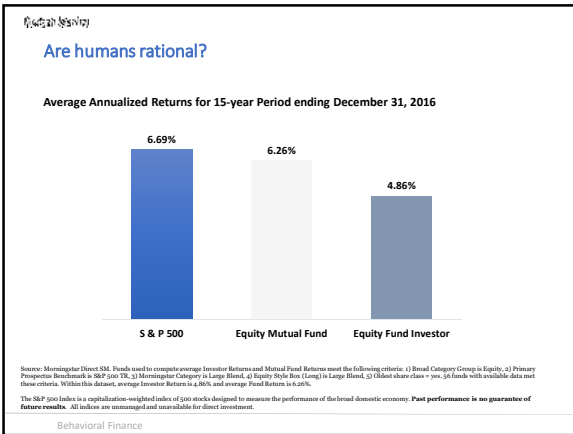
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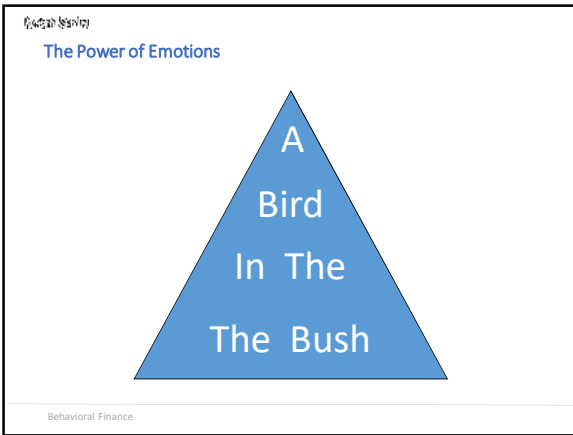
Behavioral Finance

Which is it Rational & Efficient
or Irrational & Inefficient?

Kit Mac Nee, CFP®CRPC®
Financial Advisor
Morgan Stanley
Tuesday, September 10, 2019

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The Power of Emotions

- Here is a simple puzzle. **Do NOT** try to solve it, but listen to your intuition:
- A bat and ball cost \$1.10.
- The bat costs one dollar more than the ball.
- How much does the ball cost?

• Source: *Thinking Fast and Slow*, Daniel Kahneman, 2011.

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Behavioral Biases

- Cab drivers stop driving after they reach a certain level of income.
- On rainy days, drivers reach goal quickly & quit early
- On slow days, it takes longer.
- Why do they choose to work less when it is easy and work longer hours when it is more difficult? Is this rational?



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- Liberal Paternalism
- Supposedly irrelevant factors are in fact highly relevant in predicting behavior – Tversky & Kahneman 1974.



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Topics for Discussion

- Foundations of Behavioral Finance
- Biases
- What does this have to do with investing
- Lessons for Practitioners

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Traditional Finance

- Human Beings are Rational
 - Investors have all the information
- Efficient Market Hypothesis
 - No trading advantage
 - No arbitrage
 - "The Price is Right"
 - CAPM – only risk is the correlation with the rest of the market (beta)



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- Finance/economics with reality
- Choice Architecture
- Rational & Irrational
- Inefficient



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Decision Making Bias




- Heuristics
- Availability
 - Relies on information that's handy, recent
 - Anchoring
 - Original reference points/1st piece of information
 - Similarity
 - Quick judgement
 - Appearance conforms to reality

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Cognitive & Emotional Biases

- Framing
- Narrow Framing
- Loss Aversion
- Myopic Loss Aversion
- Overconfidence
- Optimism Bias
- Endowment Effect
- Confirmation Bias
- Hindsight Bias
- Recency Bias




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Behavioral Biases

Mental Accounting




- Richard Thaler, Cornell University
- Categorize and evaluate economic outcomes, dividing current and future assets into separate groups
- Rationally, all dollars should be fungible
- We treat income and spending in a different way
- Plays a role in "Goals Based Investing"/bucketing

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Behavioral Biases

- Place assets in "buckets" for different goals
 - Safety – essential needs
 - Discretionary spending
- Match investment risk and time horizon with the goals.
- Or should a more aggregate method be used?




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Behavioral Biases

Framing

- One of the strongest biases
- Focus on mental shortcuts
- Deals with
 - Cognitive bias (errors in thinking)
 - emotional biases (distortions caused by feelings)



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תרגיל 11

I
AM
BLIND

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תרגיל 12

IT IS SPRINGTIME
AND
I AM BLIND

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Behavioral Biases

Narrow Framing

- Narrow framing consider problems as singular
- Kahneman and Lovallo
- Humans too optimistic about future outcomes – *anchored* on plans rather than results
- Too timid – focus on risks associated with a single action rather than considering risk in the aggregate
- Use intuition shared in large part by how accessible information is, or importantly, how easily that information may come to mind.
- Involves binary thinking, in terms of either/or

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Behavioral Biases

Loss Aversion

- Kahneman & Tversky found that individuals feel the pain of losses two to 2.5 times more deeply than they feel gains
- The length and severity of those losses matter
- Eric Johnson, Columbia University, older adults evidenced a pain from losses 5 times greater than any pleasure from gains –“Hyper Loss Aversion”

• Source: Prospect Theory: An analysis of Decision under Risk, Daniel Kahneman and Amos Tversky, Econometrica, 47(2), pages 263-291, page 273
 • March 1979: Hypothetical example for educational purposes only. Not representative of an actual client or transaction.

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Behavioral Biases

Loss Aversion

Example 1

Award of \$100,000 AND

(a) Certain gain of \$50,000

OR

(b) Flip a coin in which you have:

H: 50% chance of a gain of \$100,000

T: 50% chance of gain of \$0

Example 2

Award of \$200,000 AND

(a) Certain loss of \$50,000

OR

(b) Flip a coin in which you have:

H: 50% chance of loss of \$100,000

T: 50% chance of loss of \$0

• Source: Prospect Theory: An analysis of Decision under Risk, Daniel Kahneman and Amos Tversky, Econometrica, 47(2), pages 263-291, page 273
 • March 1979: Hypothetical example for educational purposes only. Not representative of an actual client or transaction.

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Behavioral Biases

Myopic Loss Aversion

- Intense pain due to losses
- 1997 study
 - Reviewed 2 portfolios on a monthly basis vs. an annual basis
 - Monthly review lead to 59% bonds and 42% stocks.
 - Annual review lead to 70% stocks and 30% bonds
 - Those with most feedback took less risk

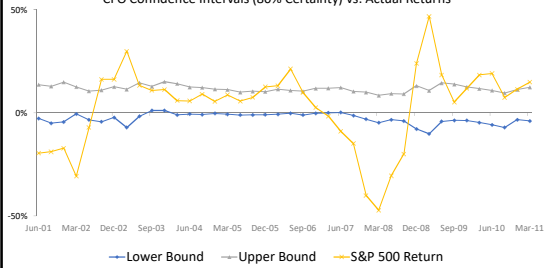
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Behavioral Biases

Overconfidence

- CFO Confidence Intervals (80% Certainty) vs. Actual Returns



Source: "Managerial Misallocation", Itzhak Ben-David, John R. Graham, and Campbell R. Harvey, SSRN working paper.

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Behavioral Biases

Optimism Bias

Belief that our chances of experiencing a negative event are lower than that of the average person.
 1980 study by Neil Weinstein; comes from both cognitive and emotional reasons. Not everyone is above average

- 120 Female College Students
- 93% Above average drivers

Protects our self-esteem

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Behavioral Biases

Endowment Effect

- Tendency to give a greater value to what we already own
- Thaler, Kahneman and Knetsch study
 - Students would not part with mugs at a reasonable price, Asked 3xs more than students that didn't own the mug
 - Boston Condo owners between 1990-97
 - Linked to loss aversion
 - Ownership-relation between people and their stuff
- Linked to Loss Aversion

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Behavioral Biases

Confirmation Bias

- The human tendency to select information or evidence which corroborates what we already believe
- Select the facts which confirm what we already believe and filter our contradictory facts, even if they are extremely relevant
- Research shows that most physicians already have in mind two or more possible diagnoses within minutes of meeting a patient, and that they tend to develop their hunches from very incomplete information, heuristics

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Behavioral Biases

Hindsight Bias

- The belief the event was really inevitable, foregone conclusion
- We knew it all along
- Fail to dig deeper
- Pay less attention to alternative explanations
- Those with greater hindsight bias underestimated volatility & had poorer results

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Which Bias?

- Edward decided to donate a sizable sum to a charity that rehomes orphaned animals. His grandfather was a famous zoologist and has fond memories with his grandfather.
- 2014-15 fiscal year Malaysia Airlines saw a dramatic decline in their market value and sales. After MH 370 went missing, it saw a net loss of 59% in the fiscal quarter. (<https://www.bbc.com/news/business-27435455>)
- In 1977, Ronald Wayne sold his share of the company Apple Computer. He sold because he feared the significant bumps might affect him as he has experienced in the past with unstable ventures.
- Two employees are presented innovations to management with H2O Sources Ltd. The first idea will help source rain clouds from one area to another. It is difficult to articulate the idea to management. Next is an idea about a new purifying tablet that can be made at minimal cost. Successfully demonstrated the tablet and presented projected costs and revenues. Which one was chosen?

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McElroy Family Business

Mike McElroy, the patriarch of the family, wants to grow McElroy Software Designs. It was started by Mike with his son-in-law Frank, and Jack Crawford, CEO of McElroy Furniture and family friend.

In order to focus on the growth of this new venture, Mike wants to sell off his manufacturing business, McElroy furniture, after 40 years. Mike comes from a long line of furniture makers in NC.

Mike, Jr. and Charles are both hesitant about selling the furniture company. They had hoped to take on the family business after Mike, Sr. retired. Neither are technology experts although they could move into management.



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McElroy Family Business

What are some of the reasons that could be causing tension and discord among the family due to the potential sale of the family business?

How can we help Mike, Sr. reframe the proposed sale of McElroy Furniture to mitigate the growing tension and discord of impending loss to members of the family?



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Closed End Funds

Benjamin Graham
 “an expensive monument erected to the inertia and stupidity of stockholders.”

- Market price vs. NAV
- Violates EMH – can’t have two prices
- Larry Summer’s – Noise Traders
 - SIF = noise
 - News
 - Noise influences asset prices
 - “THERE ARE IDIOTS. Look around”
 - Small firm effect

Misbehaving, The Making of Behavioral Economics, Richard H Thaler, W.W. Norton & Company, NY & London 2015.

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Bubbles Mania Exuberance

- Extreme forecasts based on flimsy data
- Benjamin Graham – Intelligent Investor 1949
 - P/E Ratios
 - 1937 30 stocks of DJIA ranked them based on P/E
 - Formed two portfolios
 - 10 highest P/Es
 - 10 lowest P/Es
 - Cheap stocks outperformed
 - Cheap portfolio \$10K into \$66,900
 - Expensive portfolio \$10 into \$23,300
 - Buying the entire portfolio - \$44,000
 - May not work in every period
 - Undervaluations due to neglect
 - Inflated prices by over enthusiasm
 - Inconsistent with Efficient Market Hypothesis

Misbehaving, The Making of Behavioral Economics, Richard H Thaler, W.W. Norton & Company, NY & London 2015.

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Bubbles Mania Exuberance

- Reversion to mean – can’t happen
- No such thing as a cheap stock – mispricing
- Overreactions of markets
 - Three year period Loser portfolio did better
 - With lower beta (1.03 vs 1.37)
- Robert Shiller – financial markets are too volatile
 - Means the prices are wrong “Stock Prices and Social Dynamics”
 - Used Keynes term “Animal Spirits”


Misbehaving, The Making of Behavioral Economics, Richard H Thaler, W.W. Norton & Company, NY & London 2015.

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Law of One Price

- Splitting company up should not raise value
- 3Com and Palm
- Magically worth more separated



EMH: $3\text{Com} = \text{Palm} + \text{remainder of 3Com}$

$\$40/\text{share} = \text{Palm} + \text{remainder of 3Com (12-13-99)}$

$\$100/\text{share} = \text{Palm} + \text{remainder of 3Com (3-1-2000)}$

Day of IPO divide into 2 investments
 1 share new 3Comm = 1.5 shares Palm + remainder of 3Comm

$\$82.00 = \$143 + (-\$61)$


Misbehaving, The Making of Behavioral Economics, Richard H Thaler, W.W. Norton & Company, NY & London 2015.

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Conclusions for Financial Markets

- EMH normative benchmark of how the world should be
 - No- free lunch is mostly correct
 - Active money managers don't beat the market
 - Even when all the information is out there, the prices can still be wrong. And stay wrong for a long time.
- Low opinion of the price is Right
 - Price is often wrong
 - Sometimes very wrong
 - Causes for misallocation of resources
 - Example: Housing prices, NASDAQ 2000-2002 decline




Misbehaving, The Making of Behavioral Economics, Richard H Thaler, W.W. Norton & Company, NY & London 2015.

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Good Decision Making

- Ideas conform to observable reality
- Internal logical coherence
- Know what we "don't know"
- Focus on individual goals
- Recognize loss aversion (fear)
- Educate on the subject being decided



"Ignorance is not the death of knowledge, but rather the ignorance of ignorance."

Alfred North Whitehead

Misbehaving, The Making of Behavioral Economics, Richard H Thaler, W.W. Norton & Company, NY & London 2015.

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Lessons for Practitioners

- Framing has a stronger effect on older persons than in younger adults.
- Our clients have a wide range of biases.
- The biases we use for decision making are not always wrong
- How we ask the questions in discovery
- We need to be aware of our own biases



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Lessons for Practitioners



- Seek out information which challenges our assumptions
- Evaluate this new information fairly and fully
- Focus on goals
- Add other factors, other alternatives, enrich the process to determine "real" value
- Consider context of past data as well as current circumstances

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Lessons for Practitioners

- Look at the whole picture – business cycle, geopolitical context, overall situation and goals
- Rely on consistent benchmarks against the goals
- Once you understand a behavioral problem, you can sometimes invest a behavioral solution to it.
- Mental accounting is not always a fools game.



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