



**LET'S TALK ABOUT...**

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

## Behavioural Finance

**(Part Fourteen)** In concluding this partial and simplified review of such a complex subject, we can not avoid noting how biases and psychological distortions, group and herding instincts, the roles of media, all of them contribute in taking investment decisions and markets' moves well apart from the rational patterns that the Efficient Market Theory proposes. Mathematical models and structural rules are to succumb under the weight of affective and emotional pressures. What reality actually shows is more in line with the findings of behavioural finance, and the resulting picture is one of prevailing non-equilibrium, turning cycles of euphoria and depression, bubbles and booms. But that is human nature, and the financial markets too may not be immune from its demands, for the best and the worst. Should we try to draw a moral from our short review, it could be the need for more care in evaluating and selecting investments, as well as considering some major, although often neglected points. Just to cite a few: 1) the disruptive role of overconfidence; 2) the believe that what happened in the past will repeat itself in the future; 3) the uncritical adhesion to group behaviour and dominant thinkings, even if not fully convincing; 4) seeing market patterns which actually do not exist, so undervaluing the role of randomness; 5) the fear of change; 6) selecting and interpreting data according to already biased views, even neglecting data and information we do not agree with; 7) to let emotions and personal histories prevail; 8) fail to act due to too many alternatives and data available; 9) not to recognize mistakes and write off consequent losses in time; 10) to confuse familiarity with a certain sector, area, with real knowledge, so deep to take to efficient investments. With such 10 little rules to keep in mind the subject comes to an end, although its contents will to be surely found in most of our next topics too. *(end)*

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**(Part Thirteen)** The investors' trend to move as a group (herding behaviour) and to adhere to some sort of "group thinking", in terms of current dominant theories and sentiments, is one of the major faces of behavioural finance. The origin and evolution of such patterns have been widely analyzed, with a special look into how the transmission chain works and finally affects the sub-rational investment decisions, so fuelling under- and over-reactions in the financial markets, anomalous non-equilibrium conditions, excessive cycles of euphoria-inflated bubbles and subsequent depressions and price falls. The "information contagion", in the financial as well as other fields, depends on many factors: suffice it to consider the "inventions" of financial engineering, the needs of the banking system, the market conditions, the current fashionable appeals, and so on. As relevant behavioural elements we can however point to the propension which information-holders have in sharing it with others, the diffusion and penetration levels of the media employed, the prestige and reliability of the "experts" from which information comes, as well the availability of the receivers in accepting such information and translating it into actual investment decisions. Last but not least, the time factor, that is to say its repeating. That is a really important point, which is valid for any cultural and social domains: indeed is it not true that what is repeated again and again for a long time, all the more within institutionalized environments and by supposed reliable voices, turns into a "common and undisputable truth", whichever the real truth of the starting point it comes from ? Unfortunately that is the case, and the theory of information (and disinformation) shows many evidences of it in any fields. Not to say of the distortions, changes and adaptations the information undergoes through the many steps of its way. And if the opinion spreads within a particularly influent group (prestige media, largely-followed opinion leaders and so on) then an "informational cascade" is generated, which involves many investors, eager to adhere to such thinking trend and behaviour (the Madoff "affair" may be a good example of it) *(to be followed)*

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**(Part Twelve)** Biases and psychological distortions largely affect individual and collective behaviours in the field of financial investing. The link between the individual and collective spheres gets to the so called "herding behaviour", one of the major forces in shaping markets' evolutions and trends. A cause-effect spiral thus arises, in that the dominating trend that such behaviours fuel, comes to affect other investors, so taking more and more of them, who are worried to lag trendy opportunities, to adhere to the prevailing trend. Timely strategies move according to the most "authoritative" comments and forecastings, as well as the most consolidated public behaviours. That is the main reason why the markets' history looks like a tale of almost permanent instability, which we already discussed and will furtherly review due to the topic's relevance. What we see is a succession of bubbles and boosts, according to cycles which are difficult to define as physiological or rather pathological for the overall environment, and which largely are the result of the over- and underreactions as a consequences of the investors' psychological biases and distortions. Of course such actions greatly relate to the role of the media, advisors or analysts, who often fall in the trap of adhering to the dominant and most fashionable trend themselves. Actually the huge amount of news are not always filtered by the investor, verified and critically evaluated, so taking to at least sub-optimal choices, not to say of worse outcomes. A very common case is the enormous diffusion of equity funds, which are widely purchased in order to get better returns than their reference benchmarks, despite most of them have proved unable to beat their indices, both on short and long term basis (not to say of their transaction costs and management fees). For the investors it would be more convenient, in most cases, to buy the index directly via the related ETF, so taking advantages in terms of transparency and fast trading. And yet, equity funds are extremely diffused among all categories of investors, and that may be seen as a good example of herding behaviour or group dominant thinking. But how does such syndrome spring and how do those diffused opinions spread, which become absolute truths and then affect the financial markets, shaping them through waves of bubbles and falls, without never let them find a state of stability ? That will be the subject of the coming article. *(to be continued)*

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## Behavioural Finance

**(Part Eleven)** The role of media and communication is essential in shaping the investor's personal and collective behaviours, as well as in fueling fashionable trends and related herd syndromes. The financial sector daily generates and issues terrific amounts of information, all the more as markets and products grow in their quantity and complexity, together with globalization, and a first problem then arise, in that such abundant information is not all the same efficient. Such huge amount of data needs to be selected, syntethized and evaluated in order to become a useful tool for investment decisions. Then one may ask whether the more abundant information available also takes to more clarity and better decision capabilities. Answers may be different and not at all univocal. Surely today's decision process is harder and many people tend to oversimplify it through biased mental processes, as the self-attribution we have previously discussed, by just selecting those data and pieces of information which confirm and support the investor's already built on vision. Of course more information is supposed to take to more transparency and care in choosing among alternative financial solutions. What evidence shows is the investor's attitude to mainly use information when it is more clearly reported, more understandable and issued by sources he/she trusts as reliable and perceives as more correct (being such views obviously biased in many cases). Explicit information is preferred rather than implicit or cryptical one, although the latter may be more technically correct and complete. That is perhaps the main reason why some specialized US papers and television broadcasters are so successful among financial operators and market people: their news are presented in clear and condensed ways, data are well separated from comments (a rule which many European media fail to apply). They often benefit by popular and important guests and, last but not least, by attractive (and intelligent) anchorwomen ! As for the fact that excessive information may also "divert" and take to negative decisions, just as too many laws do not always favour justice but may generate captious outcomes, well, that is another story ! *(to be continued)*

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## Behavioural Finance

**(Part Ten)** The investor's sex plays a role in how risk is perceived and investment behaviours are shaped. As in many areas, when faced to financial matters, women generally prove more rational and – odd evidence indeed – less affected by fashionable and trendy pressures. Women are more risk adverse and when coming to equity investments, they select instruments more carefully, aiming at holding them for longer times, instead of engaging in wild trading, a merely male activity which most often takes to poor results. Generally speaking, female attitude is less speculative and more oriented to those types of investment which can offer more regular returns over time. Women are much better in early evaluating potential losses which a form of investment may cause, and that is one of the main reasons for their preference for low-risk and regular-yielding instruments.

Whichever the investor's sex, the herd instinct plays a major role in financial decisions, together with the fashion effect, being such forces obviously and primarily influenced by the media and the channels of communication in general. However their information, data, comments do not take the same relevance in the investor's mind: a very interesting and common instance is the so called self-attribution: the investor's confidence (or overconfidence) in her/his own perception and evaluation is strongly increased when confirmed and supported by the media' news and data, all the more if they are reported in easy and plain terms, by sources which are supposed to be reliable, so to be perceived as more correct and unbiased. On the contrary, if such news and data are not in line with the investor's sentiment, they are discarded and she/he goes along her/his way. All of us have happened to behave such way, both in financial or other domains, and the one being without sin among us, let him first cast a stone ! *(to be continued)*

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**(Part Nine)** Evidence shows that suffered losses tend to increase the investor's risk propension and active attitudes, but the concept of risk itself may be pretty different. The one predominantly assumed in modern finance has historical-statistical basis, being related to data probabilities, deviations and variances. However such approach to risk assessment lays open to criticism, and has proven highly inadequate, in failing to consider those events which, although low likely in terms of statistical probability, may all the way take to huge and unforeseeable consequences and outcomes (the most cited "black swans" we have recently considered). Actually, in the investor's mind, the concept of risk has many complex dimensions, behind the objective and measurable ones. It is made of countless components, mixed according to many personal patterns: just to cite some among many, they may include the fear to suffer a major loss or to lose the whole capital, the more common fear of much lower returns than expected, inadequate price of held securities at times when they should have to be forcedly sold due to unexpected needs. Of course these evaluations also depend on the degree of personal knowledge and awareness and a good question may come at this point: whether more expert and professional investors perceive and assess risk in better ways, so to apply it more efficiently when selecting and placing their investments. The answer might appear pretty obvious, but it is not indeed, because "expert" and professional investors often tend to emphasize the statistical side of risk, so falling in the traps that such models involve. The good sense may be then replaced by mathematical sophistications. Moreover professional money managers and even analysts may be biased by their overconfidence and familiarity with some sectors or markets they suppose to know in deep. What is better known is supposed to be less risky, but such principle is unfortunately far from being valid and supported by real events. So, affective and sentimental biases, overconfidence, mental images the investors shapes along with their personal histories, and so on, all combine in taking to less than rational (or straightly irrational) choices. The risk factor is also differently perceived and managed according with the investor's sex, as discussed in the next article. *(to be continued)*

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**(Part Eight)** As we mentioned in the introduction to this latest set of articles, an important field of behavioural finance is devoted to the perception of risk by investors and their related stances, the psychological reasons behind their moves, the differences, if any, between the attitudes of supposed "expert" and "non-expert" market actors. Basically we should expect a theoretical behaviour based on the laws of economics and statistics, where the concept of risk is expressed in mathematical terms, as the result of past historical values considered in their variance and deviations. Although such approach in evaluating risk is inadequate and often misleading, as we have strongly and repeatedly noted, it is nevertheless some rational in its formulation. From it the Theory of Expected Utility derives, suggesting that persons choose, among the several opportunities available, the ones embodying the highest expected returns or the lowest losses, on the basis of their risk profiles. However such a model does not take into account the investor's emotional and psychological features, his/her cognitive limits and distortions, so that we do not actually find such a lot of its evidence in observing real market behaviours. The *homo oeconomicus* is a pretty rare animal, also in the great circus of financial investments ! What evidence shows about risk instead ? It tells, among many patterns, that many investors choose riskier alternatives when confronted with losses, whilst selecting more conservative instruments when their returns are already positive. Thus the goal of recovery pushes towards more hazardous stances, according to some sorts of psychological benchmarks, made up of more or less rational data which anyone elaborates by himself/herself. So more volatility is accepted if it may lead to higher expected returns, even if the traditional principle of time horizon itself is somehow distorted. Let alone the classical rules according to which more and risky investments are supposed to smooth their trends and turn rewarding over more extended times, being it no longer valid, the investor changes his/her own time horizon under the pressure of emotional hurry to get returns (or recover losses) quickly despite any theoretical model about time/reward conventional relations.

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**(Part Seven)** Other biased trends in investors' behaviours and heuristic choices may be related to the principles of "anchorage" and "representativeness". In the first case the investor's judgement is focused on the current instrument's price, irrespective of its history, past price evolutions and the reasons why. The security is then purchased just because its price is low or cheap, with no further comparative analysis. In the second case, besides the overconfidence in one's selecting skills and trend forecasting, mixed with little attention to the long term averages, the investor tends to overweight most recent experiences. That was the case during the years leading to the current crisis: when the stock market trend is constantly positive and equity yields are high for a certain number of years (that just happened from 1982 to 2000 in most markets), many investors come to think that such over-the-average returns are normal, and that such trend is to continue indefinitely, perhaps forever. A complacency syndrome arises, with diffused excesses of confidence, lack of critical sense, one of the most dangerous conditions markets may face. Such environments also take to abnormal leverages and uses of borrowing in order to furtherly increase the expected returns, together with excessive portfolio concentrations in the most supposed rewarding and trendy assets, as was the case for hedge funds, so fueling speculative bubbles moreover. The longer the trend lasts, the more dramatic are the results of its breaking and inversion, in terms of damages and losses. What has happened and is still happening in the markets proves it pretty well. In general terms such behaviours may also be linked to a certain conservatism which represents a major human feature: when scenarios and environmental conditions change, for many investors (including professionals and even portfolio managers) related adjustments take some time and answers are often slow, because judgements may be biased by a badly rooted concept of "normality". Of course, during times of huge market turbulence, such approaches may prove dangerous. *(to be continued)*

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**(Part Six)** “Mental Accounting” is a sort of cognitive distortion affecting investment behaviour as well as other economic environments. It relates to evaluations and decisions which are mentally separated whilst instead they should be combined and treated as a whole. One of the most common examples relates to the different ways in which some people use their cash flows, in that they mentally divide “ordinary” and “extraordinary” money flows. Common flows, such as salaries, are then spent and invested according to cautious and conservative principles, whilst extraordinary incomes, e.g. bonuses, prizes and so on, are placed in speculative instruments. Obviously such “distorted” behaviour pattern may be applied to shopping decisions too. Another face of this psychological splitting is the different ways in which gains and losses are sometimes evaluated. While the maximum return is expected for certain portfolio’s portions, eventual losses affecting other portfolio’s areas are removed as psychologically troubling and “consolidated” in a sort of different mental “accounting book”: so those loss-carrying instruments are not sold, so possibly determining more and more future. Portfolio managers and financial advisors may also observe other pretty common cases of “double mental accounting” in some investors: they may be extremely attentive and cautious in selecting securities within one asset class, for instance bonds, whilst turning to highly speculative and risky securities in other areas, such as the one of alternatives, or taking high risks with unhedged currency positions. However, the different ways in which risk is perceived and evaluated is going to be one of our coming subjects. *(to be continued)*.

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**(Part Five)** We have noted how cognitive biases, other psychological distortions and personal sentiments, as well as heuristics, extremely simplified or partial decision processes, greatly affect the world of investments. A relevant case is the role of overconfidence in selecting the placement opportunities and forecasting their future trends. We often see entrepreneurs and professionals belonging to a certain economic sector, taking easy challenges in investment areas they are more “familiar” with, as they trust in their knowledge and the likeliness of their operational area’s overperformance. Sometimes local investments are preferred for their potential over-return, just on the basis of a presumed better knowledge and familiarity. That is a typical condition for many US investors, although there are reasons for such orientation, namely the wide range of domestic opportunities the market offer and its average efficiency. The extreme situation is for an employee to invest mostly or fully in her/his company’s instruments, so taking a high risk and giving up the benefits of diversification. However in terms of overconfidence and general approach to financial matters and investments, psychology tells us about gender-related differences. Taking for granted (and widely supported by daily evidence) that women are sharper, more subtle and sensitive, as well as better managers of money matters, men are usually more overconfident than women and more often are wrong in their investing too. Men tend to more trading on their accounts, and the more they trade, the worse they often do. On the contrary the women’s prevailing strategy of purchasing selected instruments and holding them for longer times usually takes to better average returns.

Also feelings and actions in facing losses vary accordingly with the investor’s sex, as we will see when discussing mental attitudes and losses. Another interesting cognitive “distorsion”, the so called “mental accounting” will be our next topic. *(to be continued)*

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**(Part Four)** Besides “cognitive dissonance” there are many more psychological distortions taking to not so much rational, or straightly irrational, investment behaviours, so to induce sub-optimal returns for individuals and make the market movements a series of extreme situations, a succession of booms and sbooms, new bubbles and sudden falls, and so on, never finding its stability and equilibrium (see Minsky’s references about that). Cognitive distortions are the result of personal biases, that is prejudices, feelings and aversions, and so on. A complex problem may be oversimplified, by analyzing just a side of it or a mere part of its features (heuristics) so that the problem’s solution itself turns out as more affected by sentimental than rational elements. A very common “heuristic” choice relates to oversimplified asset allocations, when the portfolio’s parting is executed through a rough rule of thumb, for instance one third for equity, and the same shares for bonds and money market. Other cases may be labelled as “disposition effect or heuristics”: the investor tends to estimate the market’s future trend and selects her/his investments on the basis of past events, but such information is not rated and weighted according to its relevance, but rather for its vividness and the emotional involvement it generated in herself/himself. What has happened more often or has impressed more is judged as more likely. That is the psychological distortion according to which many think airplanes as more dangerous than cars, just because an air accident has immediate and worldwide resonance, contrary to much more common road accidents. Recent financial events and stories widely give evidence of such principles. A sub-class of disposition heuristics relates to investment choices in supposedly well known companies, often belonging to the investor’s professional sector or even the investors’ employing company itself. Sometimes the investment targets are the most trendy or cited companies by the media at the moment, and they are thought to be perspective better performers than market averages, despite no rational basis for such assumption. *(to be continued)*

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**(Part Three)** The first area of behavioural finance we review applies to cognitive strategies and mental models used by the investor in evaluating her/his investments and making financial choices. Obviously caution is necessary in discussing general attitudes, in this domain too, because each individual acts according to her/his strictly personal and unique patterns. However, when psychology is applied to the world of investments, some common and diffused features emerge, whose outcomes finally come to shape individual and group behaviours. Many of those psychological patterns relate to the "heuristics" concept, that is an often simplified mental path through which our minds try to solve complex problems, on the basis of priorities, personal trends, biases too, so that the final outcome often turns out to be much less rational than expected. A good example to be considered in economic and financial situations, but not just in them, is "cognitive dissonance", for which contradictory knowledge and information "disturb" the investor's mind, as well as a buyer of goods and services, so that the individual tends to ignore, or at underestimate, the information which may increase his/her psychological conflict, so simplifying the decision process. He/she reacts in a much more positive way to those information confirming and supporting his/her preconceived view. Of course such view could be far from rational and even strongly biased. Such behaviour is very common in buying decisions, for daily as well as major items, such as cars, homes and so on.

In the financial field we may cite the case of the investor in a badly performing mutual fund: he/she will likely hold the investment despite its poor returns, while hoping that such condition may stimulate the manager's strategy, but mainly for justifying his/her choice to himself and others. Such move may obviously take to further losses in the future. Cognitive dissonance is thus viewed as the mental tool aimed at adapting our current thoughts in order to justify our past behaviours and choices. It is openly irrational but is meanwhile a part of our daily lives and no one may escape it, in both small and major matters and decisions of all kinds. *(to be continued)*

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**(Part Two)** Behavioural finance, ad not just itself, widely disproves the Efficient Market Hypothesis, by emphasizing the psychological elements in the market actors' moves, first of all the investors' choices. One could point to the subtle distinction between personal behaviours and the market's one as a whole, but such argument is not that strong: the abstract market does not really exist but as a sum of individuals operating in it, despite the supports of technological devices and statistical-mathematical models. Also the supposed more rational approaches of high-profile and institutional clients versus "normal" ones are well far from being valid and proved by evidence.

Behavioural finance is a very wide and structured subject, but we will approach it in simplified terms, without any scientific pretence, but rather using examples aimed at explaining market events and eventually stimulating further readings.

Among the many sections of the psychology, when applied to financial markets, four areas may be of particular relevance, also in relation to the latest and current turmoils: 1) the cognitive strategies and the mental models the investor uses in assessing his/her investments and selecting them; 2) the way risk is perceived and connected to past and expected results; 3) the influence of communication in financial choices; 4) the relation between individual and collective behaviours, and the involvement of aggregation, fashion effects, trendy suggestions and so on.

All of them are pretty interesting and attractive topics, throwing light on the psychological features, orientations, personal history's events and influences which make the investor's behaviour not so much rational in the end, sometimes even openly irrational, and cause the market anomalies we have often discussed in the past articles, so openly colliding with the EMH, despite the many illustrious scholars and heralds of such theory, at least until the recent times of "perfect" market tempests. *(to be continued)*

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**(Part One)** The history of finance through all times and geographical areas, as well as the daily evidences from markets and investment actors, show high levels of non-rational behaviours, mainly by the investors themselves. Indeed it seems that irrationality often prevails, among euphorias, bubbles, depressions, illusions, fashions,... and the latest years' events have more and more added huge arguments to such evidence. On the other hand that should be no reasons for astonishments or negative evaluations. Actually, should the human being act in a totally rational way, he or she would be little more than machines or robots, without carrying their likings and dislikings, biases, passions, personal and cultural conditions, past experiences and heritages, worries and so on; after all, in a world which is evidently so full of irrationality, why should the domains of economics and finance be moved otherwise ? But let us steer away from pseudo-philosophical remarks and focus instead on this subject aimed at better explaining the financial markets and the selection of their opportunities by the investors. The psychology of markets is a pretty young discipline, the first researches and theoretical assessments dating back from the early '900, but its development and structuring has been wide and deep, more and more attentive to the evolutions of Wall Street, so to take some of its scholars to top recognitions and even to Nobel graduations. Indeed the behavioural finance's empirical evidences and theoretical conclusions strongly clash with the sophisticated Efficient Market Hypothesis, that is the theory which had dominated both in the universities and among the Wall Street's most trendy and smart actors for many years, taking some of its gurus and prominent scholars to the Nobel coronations too. We remind that the EMH (previously discussed in the Financial Lexicon) was based on the assumptions that all available news about the investment targets were available to the whole community of investors, so that the market was always and definitely "efficient", in fixing fair prices. The investor's behaviour could be but rational, in that his/her choices were to be perfect mixings along the personal scales of expected returns and accepted risk levels. *(to be continued)*

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