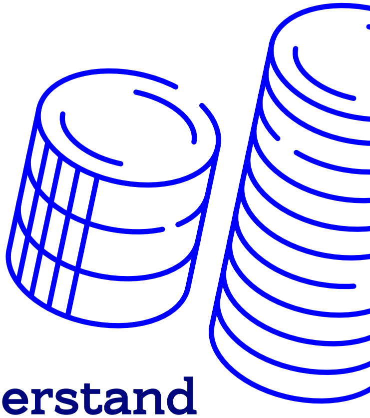
Begin

Why it's important to understand investor behaviour

Bank of Ireland



Why it's important to understand investor behaviour

"What is required for successful investing is a sound intellectual framework for making decisions, and the ability to keep emotions from corroding that framework."

-Warren Buffett –CEO Berkshire Hathaway

Let's start with a question:

A bat and a ball cost €1.10.

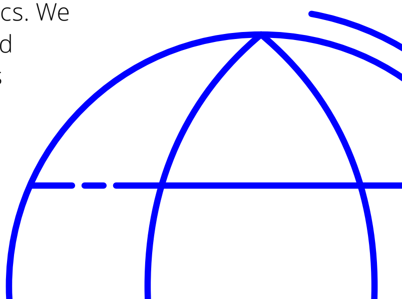
The bat costs €1 more than the ball.

How much does the ball cost?

This is a puzzle posed by Daniel Kahneman in his book 'Thinking fast and slow'. The likelihood is that such a straight forward question didn't require too much effort to come up with the answer of 10c. If this was the answer you intuitively came up with, I'm sorry to say, it's actually incorrect!

So right now, you are probably reading the question again, and if coming up with the correct answer asking "how did I get that wrong the first time?" Don't worry because, based on similar experiments carried out over many years, thousands of university students around the world also regularly get it wrong!

The above example illustrates a fundamental flaw of human nature which leaves us prone to jumping to conclusions and not always thinking things through rationally. Behavioural Finance studies the psychology of decision making. It recognises that humans are emotional and sometimes irrational beings. When it comes to investing, people rarely behave according to the assumptions made in traditional finance theory and economics. We are influenced by our biases and past experiences, and often



use rules of thumb or shortcuts when making both simple and complex investment decisions.

These decision making behaviours are called biases and relate directly to how we process information in order to make decisions. When investing we need to recognise that such biases and rules of thumb exist and try to understand just how much they impact our day to day decision making. Importantly these biases are shown to affect professional investors just as much as the novice investor.

Removing these biases is difficult, but we can recognise they exist and understand their potential impact. This can help our financial decision making and in-turn improve investment outcomes.

Let's look at a couple of examples where bias can impact decisions:

Loss Aversion:

Research by behavioural scientists have estimated that the pain of loss is roughly two and a half times greater than the pleasure of the equivalent gain. In simple terms, losing €10 feels much more painful than the pleasure of finding €10.

The concept of loss aversion is probably one of the most important in Behavioral Finance as it suggests that most investors will feel the pain of loss much greater than they'll appreciate the pleasure of equivalent gains. This is why your Financial Advisor will take time with you, before you invest, to assess your attitude to risk and tolerance for loss, to set realistic return expectations and to discuss how you might react to the downside risks of potential investments. These are all areas where identifying the impact of risk aversion is so important.

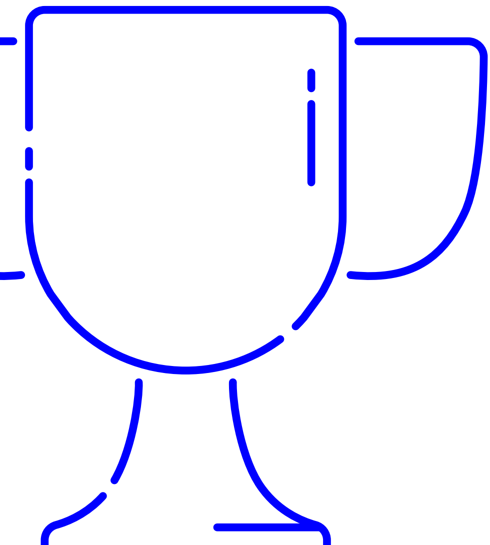
Have you had any service or product provider offer you a 6 month free trial recently? I'm sure you can think of a few. They offer you a free trial period, you click the button to accept, and next they want your credit card number in order to proceed with this special offer. Annoying isn't it? This is an example of companies taking advantage of consumers' tendency for 'loss aversion'.

Most people simply don't like to ever give back something that they already have, which is the basis behind the free trial period. Marketing gurus recognize that many of us will typically just keep the product or service going until the payments eventually start to come off our credit card. They also recognize that we are prone to suffer from inertia! Many of us simply won't be bothered to contact the card provider to cancel the subscription. So signing us up and getting the credit card details at the start mean that the combination of loss aversion and inertia convert us to becoming a paying subscriber!

Prospect Theory:

In financial terms the amount of joy gained from receiving €50 should be equal to a situation in which you gained €100 and then lost €50, as both situations result in a net gain of €50. Prospect theory, as part of loss aversion, has proven that investors value losses and gains differently. Investors typically make decisions based on the perceived value of losses or gains around a reference point, rather than on the final outcome itself.

This was demonstrated by research in 1995 of Olympians which found that in many instances bronze medal winners were happier with their results than silver medal winners. Why? Because the silver medal winners considered a gold medal as their starting reference point, and in winning a silver medal saw themselves not as second to the winner but as 'first loser'. However, the bronze medal winners' reference point was focused downwards towards fourth, and so in this instance any outcome above not winning a medal at all is a perceived gain!



So our reference point is important when dealing with gains and losses. Investors often take a higher level of risk in order to recover a previous loss than they would be willing to take if they were investing simply to generate a future return.

Investors reference points change following a number of years of strong returns as the value of their investment increases. Someone that started with a €50,000 investment that grows to €65,000, then falls to €60,000, typically may not see this as a gain of €10,000. They may see a loss of €5,000, as their reference point had moved up to €65,000.

In a low growth world investors are inclined to go further out the risk spectrum in search of returns. Recognising and understanding the concepts of loss aversion and prospect theory can help us to expect realistic future investment returns.

Anchoring:

Decisions can be anchored by the way information is presented. Looking back at recent past returns creates a psychological benchmark that can carry a disproportionately high weight in our decisions about expected future returns. Once a forecast or expected return is communicated for any investment, this number becomes the benchmark (or anchor) from which success or failure is subsequently

assessed. The effect of this is that any outcome below this benchmark return, even if assessed over short time periods, may be perceived as potential failure and can possibly lead to an inappropriate change of investment strategy.

A way to counter the impact of this anchoring effect is to adopt a buffer or range of return. Instead of expecting a 5% average return over time, maybe allow a buffer of +/-2% or be comfortable with a range of returns between 3%-7% over time. It is also important to avoid examining performance over a short term period to avoid taking action, often for the wrong reasons at the wrong time

Availability Bias:

We have all been guilty of putting off until tomorrow (or next month!) what can be done today. This can be a real barrier to successful financial planning. One cause of our tendency to procrastinate is the 'availability bias' which suggests that recently observed or experienced events can strongly influence our investment and financial planning decisions. Volatile markets create nervousness preventing investors from making important long term decisions. In contrast, benign, rising markets can see us chase unrealistic future returns, and sometimes make irrational investment decisions. This can cause investors to fall into the trap of buying high and selling low – when the opposite (buying low and selling high) is likely to be more successful.

Some investment products are specifically structured to counter this bias. One example is auto-enrollment into a pension scheme - where the scheme member has to opt-out, rather than opt-in. Another example is 'life-style' or 'target-date' funds – where the investment decisions relating to buying certain assets are pre-determined based on the investors age or number of years until retirement. In addition, by drip-feeding your money into your investments (and consequently into the markets) by making regular monthly contributions, you avoid the risk of trying to time your investment based on recent performance.

The above are just a few areas that can help our understanding of the behaviours that can help, or hinder, achieving our long-term goals and objectives.

We are irrational decision makers, primarily driven by emotions. Buying high and selling low may be irrational but it feels comfortable. Mistakes are often driven by fear, and it's not irrational to feel scared during uncertain market conditions. We will never be able to control all of our innate biases and behaviours, but we can certainly work on learning to recognise and control them. This in turn can potentially make us better, more successful, investors.

If you would like to learn more about any of the above concepts the books "Nudge" by Richard Thaler and "Thinking Fast and Slow" by Daniel Kahneman are excellent places to start.

If you're still wondering - the correct answer to the bat and ball question is the ball costs 5c. If the bat costs €1 more than the ball, and the ball was 10c (as many may have guessed) it would make the price of the pair €1.20. So a bat is €1.05 and a ball is 0.5c.

DID YOU KNOW...

Behavioural biases indicate that investors are likely to:

- Underestimate the probability of extreme outcomes
- Be too optimistic about the future
- Worry about the consequences of taking an action versus the impact not doing so
- Worry about departing from the norm
- Be biased towards what they are familiar with
- Overweight the present compared to the future
- Disproportionally weight the risk of losses over the potential for gain

"Investing isn't about beating others at their game. It's about controlling yourself at your own game."

–Benjamin Graham author 'The Intelligent Investor'.

WARNING: Past performance is not a reliable guide to future performance.

WARNING: The value of your investment can go down as well as up.

April 2021