Getting emotional about money: With behavioral finance, Barclays helps clients understand the complex psychology of investing

Wolcott Wheeler

(212 526-2661

wolcottwheeler@barclays.com

Barclays takes the concept of “market psychology” to an entirely new level

During the dramatic worldwide stock market selloff in October 2014, declining equity prices triggered a panic, and investors stampeded. After peaking at 17,350.64 on September 19, the Dow Jones Industrial Average (DJIA) fell to 15,855.12 on October 15, a drop of 8.6%. The S&P 500 dropped 9.8% from its September 19 peak at 2,019.26 to 1,820.66 on October 15.

Two weeks later, the DJIA rebounded 9.7% and the S&P 500 jumped 10.8% to hit a high of 2,017.45 on Friday, October 31.[[1]](#footnote-1)

[insert chart(s)]

|  |  |
| --- | --- |
| In October 2014, markets plummeted – and then rebound rapidly | Figure 1: Chart Title |
|  |
| Source: |

Millions dumped their shares in the heat of emotion on or before October 16. How do they feel now?

Maybe you were one of the millions who got caught up in the avalanche of market emotion. Maybe you joined the sell crowd in one of the other market corrections of the past 20 years. You’re not alone. This is a common emotional experience among investors, and this is the reason why Barclays established the world’s first behavioral finance department in a bank in 2006. Behavioral finance analyzes the powerful role that emotion plays in triggering investor decisions.

Since this is *not* liable to be the last market correction we’ll witness, it’s important to understand the significance of behavioral finance and its impact on investment decision making.

In 2002, a Princeton *psychology* professor named Daniel Kahneman startled the world when he won the 2002 Nobel Prize in *economics* for his pioneering work in behavioral finance.[[2]](#footnote-2) Previously classical finance as formulated by Adam Smith was predicated on *homo economicus* – a wholly rational being who *only* makes financial decisions based *always* on logical self-interest.[[3]](#footnote-3) But now we see that being is as mythical as Rousseau’s “natural man” – when it comes to money, we all get a little emotional. As a result, in many sectors of financial services, behavioral finance is supplanting modern portfolio theory (MPT), which has held sway since the 1950s.[[4]](#footnote-4)

To provide a baseline for our discussion of investment analysis, Figure 1 demonstrates that if we observe a 12-year holding period, profits result. The chart illustrates that obtaining good investment results over the long term is a realistic goal.

|  |  |
| --- | --- |
| No investment is a sure bet – but this chart is certainly thought-provoking in its implications | Figure 2: A 12-year holding period demonstrates the virtues of the long view |
|  |
| Source: |

What prevents us from realizing these optimal long-term results? In his research, Kahneman identified a range of cognitive biases that produce unwittingly self-destructive behavior among investors. We’ll discuss six major biases – you may have come across them in your own decision making:

* Loss aversion
* Framing
* Recency
* Anchoring
* Representativeness
* Availability

We’re more afraid of losing $1,000 than possibly gaining $10,000

Loss aversion

It’s a human truth that the prospect of a loss is more fearful to us than the prospect of a gain is potentially pleasurable to us. We’re more afraid of losing $1,000 than possibly gaining $10,000. Kahneman noted: “A central conclusion of the study of risky choice has been that such choices are best explained by assuming that the significant carriers of utility are not states of wealth or welfare, but *changes relative to a neutral reference point.* Another central result is that changes that make things *worse* (losses) loom larger than improvements or gains.”[[5]](#footnote-5) (Emphasis added.)

However, during a market shakeup, investors panic and sell blindly because they’re so afraid of losing everything, they lose sight of basic axiom of investing: *buy low, sell high*. Instead they sell low and buy high.

Would you prefer a $5 discount or avoid a $5 surcharge? It’s the same change in price, but the way it’s framed can affect consumer behavior

Framing

Framing occurs when the context we use to frame a situation comes to define that situation. For example: would you prefer a $5 discount or avoid a $5 surcharge? It’s the same change in price, but the way it’s framed can affect consumer behavior.[[6]](#footnote-6)

In investing, “framing” is crucial – through what time horizon do we view our investment decisions? If we decide based on a one-year horizon, we act on short-term information. But if we frame our choices on a 10-year horizon, we can take in the long view, as we see in Figures 2 and 3.

|  |  |  |
| --- | --- | --- |
| Figure 3: For optimal returns, look 10 years ahead |  | Figure 4: A one-year horizon (in gray) skews investments returns; a 10-year horizon (in blue) produces even returns |
|  |  |  |
| Source: |  | Source: |

Recency

When we have a recency bias, we tend to extrapolate recent events into the future indefinitely. Before this year, many investors assumed that buying Apple stock was a sure thing; it only went up. But what goes up…

Anchoring is the tendency to base too many assumptions on one piece of information

Anchoring

Anchoring is the tendency to base too many assumptions on one piece of information when making decisions, usually the first piece of information we obtain on the subject. For example, if I’m a used car salesman, I tell you that the car you’re interested in is priced at $7,000, when really it’s worth $5,000. As you bargain me down from $7,000, you may think you’re getting a bargain, when in reality you’re being overcharged. But you have already your anchored your negotiations to the $7,000 figure.

Representativeness

Under uncertain conditions, investors are prone to believe that a history of an exceptional performance by a given firm is “representative” of how the firm will continue to perform into the future. Here the Apple example comes back into play: “Apple has been performing so exceptionally for so long, it’s reasonable to expect that outperformance will persist. Why would it change?” This ignores the fact that other factors can enter the picture and discredit that assumption.

It can be a mistake to make a decision based solely on available information

Availability

When we make a decision based only on available information, this forms another major cognitive bias. “My uncle got burned on tech stocks, so I’m keeping away from them.” Does this mean *all* tech stocks are pitfalls? Hardly. Have you heard about Apple?

These misapprehensions are among the most common ones that investors make. Maybe you’ve spotted one of your own unconscious tendencies in the above list when it comes to investing.

The major question here is, as an investor, how do I become aware of my biases, and then how do I work against them?

The Barclays Financial Personality Assessment reveals what makes a client’s investment outlook unique

Risk attitudes

* **Risk tolerance:** how much risk can you stand?
* **Composure:** what’s your stress level? At what point do you start to panic?
* **Market engagement:** how engaged are you with the market? Are you a market watcher?

Decision styles

* **Perceived financial expertise:** how do you view your financial savvy?
* **Delegation**: how much do you like to delegate investment decision making?
* **Belief in skill:** do you have faith in the expertise of financial advisors?

After a client takes the Financial Personality Assessment, a Barclays Investment Representative sits down with him or her to discuss the proclivities the test has uncovered and to determine what kind of portfolio both satisfies the client’s need for emotional comfort in the investment arena and meets his or her requirements for investment growth. This way, clients are better able to weather the emotional ups and downs of investing in today’s fast-moving market.

However, many times, clients can’t embrace the perfect (ideal) solution suggested by their FPA. In that case, behavioral finance recommends that it’s better to make them comfortable with another solution close to the right answer. This is known as *smoothing* – taking them to the median point.

Barclays Investment Representatives work closely with clients so that they can make the best investment decisions in the cheapest and most efficient way, helping them through market turbulence and advising them how to avoid likely pitfalls.

Follow the four basic rules of investment

1. **Put your wealth to work.** Get invested. Don’t leave your money sitting idle. As Figure 1 shows, long-term investing yields demonstrable results.By providing capital for others, you are rewarded via a risk premium. Over the last six years, many investors have been reluctant to deploy their wealth, but leaving capital fallow can cost a moderate-risk investor 3% of foregone returns a year.[[7]](#footnote-7) That’s a very costly decision.
2. **Diversify to reduce risk.** Placing 100% of your holdings in equities – or any single asset class – is too risky. In a given asset class, your investment can go to zero and to zero forever, so it’s vital to diversify.
3. **Ensure you have enough liquidity to undergo the investment journey**. This way, you avoid being forced to sell at a time not of your choosing. As John Maynard Keynes remarked, “The market can stay irrational longer than you can stay solvent.”[[8]](#footnote-8)

As a result, hold onto liquidity. In addition, you have to build up your “emotional liquidity” – you have to be psychologically prepared for the normal ups and downs of market gains and losses.

1. **Rebalance.** Sell asset classes that have risen in value and purchase those that have fallen, so you can buy low and sell high. Understand your own investment psychology. Because we all exist in a zone of anxiety, you have to live with market fluctuations. Keep your emotional liquidity in reserve – your portfolio will drop in value sometimes.

Behavioral finance now constitutes the basis of Barclay’s investment philosophy

Behavioral finance is predicated on a basic truth: we’re human, all too human. When markets jump, we deviate from optimal financial decisions to obtain short-term emotional comfort (relief from stress). We focus on the immediate – not the long term. We make decisions based on the present – the path of least resistance. We seek optimal emotional comfort for the present, not the long term. Because our mindset in the moment makes us stressed and anxious, it compels us make costly decisions.

To be successful investors, we have to accept we’re human and accept the fact that often we make investment decisions on an emotional basis. With its in-depth understanding of behavioral finance, Barclays partners with clients to mitigate their anxiety and help them be prepared for the journey to an advantageous portfolio.

1. Jon C. Ogg, [The Stock Market Joke of October: What Sell-Off?,](http://247wallst.com/investing/2014/10/31/the-stock-market-joke-of-october-what-sell-off/) 24/7 Wall St., October 31, 2014. [↑](#footnote-ref-1)
2. “[Daniel Kahneman](http://en.wikipedia.org/wiki/Daniel_Kahneman),” Wikipedia, November 15, 2014. [↑](#footnote-ref-2)
3. Allan Millar, [Interview With Greg B Davies, Head Of Barclays Behavioural Finance](http://www.seeitmarket.com/interview-greg-b-davies-barclays-behavioural-finance-13577/), See it Market, April 19, 2014. [↑](#footnote-ref-3)
4. [Behavioral Investment Management: An Efficient Alternative to Modern Portfolio Theory](http://www.amazon.com/Behavioral-Investment-Management-Efficient-Alternative/dp/0071746609) by Greg B. Davies and Arnaud de Servigny (McGraw-Hill, 2012) focuses on this theme. [↑](#footnote-ref-4)
5. Daniel Kahneman, Jack L. Knetsch, Richard H. Thaler, [“Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias,”](http://www.princeton.edu/~kahneman/docs/Publications/Anomalies_DK_JLK_RHT_1991.pdf) *The Journal of Economic Perspectives, 5(1)*, p. 199, Winter 1991. [↑](#footnote-ref-5)
6. “[Loss aversion](http://en.wikipedia.org/wiki/Loss_aversion),” Wikipedia, November 4, 2014. [↑](#footnote-ref-6)
7. Davies, Greg. Overcoming the cost of being human, p. 3. [hyperlink to be added once Compliance approves Greg’s revision.] [↑](#footnote-ref-7)
8. John Maynard Keynes, [The Quotations Page](http://www.quotationspage.com/quote/38206.html). [↑](#footnote-ref-8)