

## COVER STORY

# ALL IN YOUR HEAD

## USING THE PRINCIPLES OF BEHAVIORAL FINANCE, ADVISORS CAN HELP THEIR CLIENTS BETTER UNDERSTAND THEIR INVESTING IMPULSES

BY ROBERT F. KEANE

**A**LBERT EINSTEIN ONCE REPORTEDLY SAID, “ONLY TWO THINGS ARE INFINITE, THE UNIVERSE AND human stupidity, and I’m not sure about the former.” While the great physicist’s assessment of his fellow homo sapiens is undoubtedly harsh, it is amazing how many people seem to make the same mistakes over and over again. It’s a problem that has intrigued social scientists throughout the modern era and led to a number of new fields of study. Among those has been behavioral finance, which attempts to better understand how cognitive errors and emotional biases tend to influence the decisions made by many investors. Most observers trace the origins of behavioral finance to a

paper on prospect theory written in 1979 by Amos Tversky and Daniel Kahneman (winner of the 2002 Nobel Prize in economics for his work in the area). Other groundbreaking studies were conducted by academics such as Richard Thaler (University of Chicago), Robert Shiller (Yale), and Meir Statman (U.C. Santa Clara). In their wake, a large number of books and academic research papers have been written on behavioral finance. The field is extensive and we won’t be able to address all of its intricacies in one magazine article, but at its most basic, behavioral finance derives from the idea that investors engage in a number of irrational behavior patterns that can be readily identified.

As knowledge of the subject becomes more widespread, a growing number of advisors and other financial professionals have begun using those principles in their daily practices on both the individual investor level and in money management. The first is probably most crucial for advisors, and entails identifying behavior that is less than helpful to the client’s long-term

financial health and taking steps to modify or avoid that behavior. The second area involves attempting to exploit behavioral mistakes made by other investors in order to reap outsized gains in the market.

As is often the case with any new area of research, there’s still a great deal of debate about the applicability of the theory. However, advisors owe it to their clients, and to themselves, to become familiar with the theories and their possible application.

“I believe that the things that the behavioral finance people have uncovered, these systematic cognitive errors that people are prone to, are real,” says David Yeske, who heads up the fee-only firm of Yeske and Company in San Francisco. “I see them in my clients every day.”

Fee-only advisor Curt Weil of Weil Capital in Palo Alto, California, discovered behavioral finance through the process of trying to best serve his clients. “My first interest in this was as an investor myself,” he explains. “I wanted to explore the wired-in errors that I’m prone to, like other humans, and to eliminate those errors to the best of

my ability in managing my clients’ money. Then I started to recognize that this would be a good thing to use with clients that had made, shall we say, embarrassing errors. If I can explain to them that they made a mistake not because they’re a bad person or they’re stupid, but that we’re just wired in this fashion, it lets them off the hook. Now they can view it as a learning experience for which they’ve paid a high tuition.”

What Yeske, Weil, and other advisors who attempt to use the lessons of behavioral finance with their clients continually point out is that unlike Einstein’s assessment at the beginning of this article, the predictable errors that investors make are due to human evolution, not individual stupidity.

“The human brain is wired by millions of years of evolution not to process statistics, but for social interactions,” explains Yeske. “It doesn’t work like a computer and process a problem by going from A to B to C to D; it jumps from A to D. That works very well in our normal everyday social interactions. It doesn’t necessarily work well when we’re making financial decisions.”

Oakland, California-based fee-only advisor Pat Jennerjohn of Focused Finances echoes that sentiment when she notes, “Things that helped us out in the jungle aren’t real helpful on Wall Street.” To assist her clients in understanding that their less-than-helpful investment impulses are the result of evolutionary processes rather than personal failings, Jennerjohn insists that they each take a workshop that she conducts on the fundamentals of behavioral finance.

“We talk about heuristics, which are decisions we make quickly without any kind of linear thinking. A lot of these are hard-wired into our brains through evolution and are useful skills that have helped us become the species that we are now, but these useful skills when applied to more complex situations often lead to poor decisions. They aren’t the kinds of skills that look at many, many years of historical beta and trends. I teach them to recognize the situations where faulty thinking might come into play and then how to step away from it.”

### Irrational Behavior

Just about any advisor is likely to have a wealth of stories about actions that their clients have made or wanted to make that didn’t make any objective sense and certainly would not produce the desired result. Dan Moisan of Spraker, Fitzgerald, Tamayo & Moisan, in Melbourne, Florida, has studied behavioral finance extensively and is the author of “Using Behavioral Finance to Improve Client Communication,” a paper posted on the FPA Web site ([www.fpanet.org](http://www.fpanet.org)). He’s seen a number of these cognitive errors first hand.

“A real common one is confirmation bias,” he points out. “That’s a fancy way of saying that people hear what they want to hear. They’ll accept information readily if it tends to back up their [preformed] opinion, and they tend to discount or reject information that goes against their way of thinking. We have that bias in part because we get so much information every day, so much stimulus, that the brain has to have a way of sifting through it. So it takes the mental shortcut. That’s what a judgmental heuristic is—basically a mental shortcut. It’s not necessarily a bad thing because it allows us to process all this information, but it can cause us to place too much emphasis on bad information and to discount or reject good or useful information.”

“The most common mistake is to look at the immediate past and then project it into

the future indefinitely,” adds Pat Jennerjohn. “If the market went down yesterday, you’re going to be a lot more pessimistic about the future than if the market went up. We also tend to be very confident and think things are more likely if we’ve had a personal experience [supporting that confidence] or if [those memories] are more vivid in our minds.” In her workshops, Jennerjohn asks clients to judge which of two unlikely causes of death is more common—being attacked by a shark or being hit by something falling from an airplane. The class almost always chooses the shark attack, although the second occurrence happens more frequently.

“That’s called salience or availability. You tend to overestimate the likelihood of something happening if you’re familiar with the occurrence. People here in California go out and buy an earthquake kit right after we’ve had an earthquake, or people go and buy

lottery tickets at the store that sold a winning ticket. That kind of behavior is great if one member of your tribe has just discovered a really delicious fruit, but you can’t apply that in situations where you have to be very objective and look at long-term trends and [sometimes] go against your instincts. The thing that you ought to do right now is probably the thing you least want to do.”

A common error that Yeske has experienced is what he refers to as the representativeness heuristic, where people assume that a “good company” is a good investment. “We can demonstrate that those companies that can be identified in some objective way as good companies, as admired companies, as companies with really excellent financial ratios, tend to be really bad investments.

“Inappropriate extrapolation” is another behavioral error, says Yeske. “People tend to give too much weight to recent events when

## DEFINING BEHAVIORAL FINANCE TERMS

**Anchoring.** The tendency of investors to become attached to a specific price as the fair value of a holding.

**Attachment bias.** Holding onto an investment for emotional reasons, such as “my grandfather left me this stock.”

**Cognitive dissonance.** The challenge of reconciling two opposing beliefs, which often results in remembering the positive parts of an experience but forgetting the negative.

**Confirmation bias.** The natural human tendency to accept any information that confirms our preconceived position or opinion and to disregard any information that doesn’t support that preconceived notion.

**Fear of regret.** The tendency to take no action rather than risk making the wrong one, which often causes an investor to hold onto a stock that’s losing value, because if they sold and it rebounded they’d feel even worse.

**Hindsight bias.** The 20/20 vision we have when looking at a past event and thinking we understand it, when in reality we may not.

**Inappropriate extrapolation.** The tendency to look at recent events (or market per-

formance) and assume that those events or conditions will continue indefinitely.

**Mental accounting.** This entails looking at sums of money differently, depending on their source or the intended use.

**Outcome bias.** The tendency to make a decision based on the desired outcome rather than on the probability of that outcome.

**Overconfidence.** This is the tendency to place too much emphasis on one’s own abilities. It often works hand in hand with confirmation bias.

**Prospect theory.** Originally developed by Daniel Kahneman and Amos Tversky, it describes the different ways people evaluate losses and gains. Their research found that losses have a much greater negative impact than a commensurate gain will have positive.

**Self-affirmation bias.** The belief that when something goes right, it’s because you were smart and made the right decision. If it doesn’t work out, it’s due to someone else’s fault or simply bad luck.

**Status quo bias.** The tendency of investors to do nothing when action is actually called for.

extrapolating into the future. If you have a couple of months of bad market returns, for example, people start to feel like it's going to go on forever, and they want to turn their financial plan upside down to adapt to that. We have to keep bringing them back to the broader context and pointing out that what they're feeling is not unnatural."

Risk aversion is among the most common occurrences. "Risk aversion is hard-wired into our brains," observes Shiv Mehta, head of asset allocation for ING Investment Management. "If you think about it, we are very naturally, by our evolution, risk-averse creatures. You see risk aversion in financial terms often in 401(k) plans, where people invest all of their money in stable value accounts. We probably all have more cash than we need to. Why? Because we are all more afraid of creating a situation where we have a loss. The marginal utility, if you like, of a gain is not as high as the reverse marginal utility of a loss."

"Mental accounting is another one that you'll come across, where people treat a pot of money differently because of what it's for or where it came from," notes Moisand. As an example, he points to a young worker who is afraid to take any risk in her 401(k) because that's her retirement money. "When they've got 20 or more years until retirement, they could take on some risk."

Anchoring is a behavior that Weil brings up. The example he uses is of a situation where he advises a client to sell some stock in a company where the client once worked. "They have a hard time doing that because they remember when it was \$150 a share and now it's only \$70," he says. "They're anchored at that \$150-a-share price. So I turn it around for them and say, 'Well, then, you're probably anxious to sell your home in Palo Alto. It's \$1.3 million now and remember, it was worth only \$35,000 back in 1972, so the real value is only \$35,000.'

"They're anchored to a stock price from 1999 as the price it should be, but that has nothing to do with reality. If I can show them the reverse of that and how irrational it is, then they're open to the fact that maybe the real value of that stock today is \$70, because that's where it's trading."

### Behavioral Investing

While there seems to be a consensus that there are certain cognitive errors to which all human beings are prone, there are two schools of thought on whether those errors can be exploited in an investment strategy.

"I don't put any stock in being able to get outsize profits by exploiting systematic decision-making bias," says Moisand. "Most of the academics will tell you that people would be better off just investing in an index fund, which is exactly the same thing

that adherents to the efficient market theory tell you. They're on almost polar opposites as to whether it can be exploited, but they both wind up in the same place."

"Many people say that the findings of behavioral finance prove that the markets are not efficient," adds planner Yeske. "I don't believe that's true. In fact, I think these cognitive errors occur randomly and errors are randomly distributed among the population or among decision-makers. As a result, I think they're real at the individual level, but self-canceling when you start to aggregate to the market level. So I don't use it to inform my investment philosophy, but I do use it in work with individual clients."

Mehta does use behavioral finance principles, but not to take advantage of the errors of others. Instead he relies on the concept outlined by James Surowiecki in his book *The Wisdom of Crowds* (Random House, 2004), which posits that large groups of people are smarter than an elite few at solving problems, fostering innovation, and coming to wise decisions.

Before Mehta's asset allocation team meets, they are asked to cast a formal vote on their suggested position. The idea is that while each individual member of the team is unlikely to make a bull's-eye forecast, their collective wisdom, when averaged, is much more likely to provide an accurate forecast.

"Last June we got our asset allocation group to write down where each thought the S&P 500 was going to end up at the end of the year; [collectively] we were within 10 basis points. Not even the best of us individually was as accurate. We use the initial vote as a behavioral finance tool, which helps us get a view, and then we debate that view."

Mehta stresses that for the wisdom of crowds to come to fruition, a number of conditions have to exist. First of all, the members of the group must have expertise and a diversity of opinion. "Third, the group needs to be non-contaminated," he explains. "You can't have a group of people who all get together and the CIO is in the room and so now everyone wants to be in line with what the CIO thinks. The wisdom of crowds only works in a positive sense if you have those three attributes."

Silvio Tarca, lead manager of JP Morgan's Intrepid fund family, firmly believes that the principles of behavioral finance identify inefficiencies in the market and that those inefficiencies can be exploited for profit. "We are consumers of academic behavioral finance research, but we are

## TO LEARN MORE ABOUT BEHAVIORAL FINANCE . . .

### BOOKS

**Advances in Behavioral Finance**  
by Richard Thaler  
(Russell Sage Foundation, 1993)

**Against the Gods: The Remarkable Story of Risk**, by Peter L. Bernstein  
(John Wiley & Sons, 1996)

**Choices, Values, and Frames**  
by Daniel Kahneman and Amos Tversky (eds.) (Cambridge University Press, 2000)

**Inefficient Markets: An Introduction to Behavioral Finance**, by Andrei Shleifer  
(Oxford University Press, 2000)

**Investment Madness: How Psychology Affects Your Investing and What to Do About It**, by John R. Nofsinger  
(Financial Times/Prentice Hall, 2001)

### ONLINE

**Incorporating Behavioral Finance Into Your Practice**  
by Michael M. Pompian and John M. Longo  
[www.fpanet.org/journal](http://www.fpanet.org/journal)

**Using Behavioral Finance to Improve Client Communications**  
by Dan Moisand  
[www.fpanet.org/member/practice\\_center](http://www.fpanet.org/member/practice_center)

**Behavioral Finance: An Alternative Investing Future?**  
by Mark P. Hurley and Tom Fuller  
[www.fpanet.org/journal](http://www.fpanet.org/journal)

**Introduction to Behavioral Finance**  
by Undiscovered Managers  
[www.jpmorganfunds.com/undiscovered-managers/research](http://www.jpmorganfunds.com/undiscovered-managers/research)

practitioners also,” he says. “We want to know how these principles can be implemented in a portfolio management context to make money for our clients.”

All five of the funds Tarca manages use a strategy that is contrary to the irrational behavior of other investors. The first behavior he looks at is the tendency of investors to be overly optimistic about past winners and overly pessimistic about past losers. As investors rush to buy into a stock that has been a recent winner, they drive the price up to the point where it becomes overvalued. Conversely, as investors shun past losers, the prices of those stocks become undervalued. “Representativeness is one of principles at work here,” he explains. “Investors have demonstrated a tendency to think of past winners as ‘good companies’ and thus good investments, but the overpriced stock of a good company is not a good investment.”

Two other factors that Tarca considers are a valuation anomaly, meaning that cheap stocks outperform expensive ones over time, and a momentum anomaly—stocks with price momentum continue to outperform. In stock selection, Tarca and his co-managers use a proprietary multifactor model to help them identify mispriced stocks. What he says they want is “cheap stocks with strong momentum.”

Tarca also seeks to put other behavioral finance principles into play. In looking at the behavior of stock analysts, he’s noticed a predisposition toward overconfidence early in the fiscal year, backed up with a

confirmation bias. “With Intrepid Funds, we try to use posted earnings revisions to capitalize on this anomaly.”

### Avoiding Cognitive Errors

Financial professionals who have recognized the inappropriate behaviors to which human beings are prone in their investment life have a common method for dealing with those behaviors—be disciplined and stick to the plan.

Jennerjohn has seen more than her share of clients who were frantic to make some movement with their portfolio. “I always tell them that a financial decision, no matter how urgent it feels, can always wait until tomorrow,” she explains. “A lot of times if you just wait a day, the impulse to do something just kind of evaporates. I also have a good discussion with them about their individual portfolios and what their objectives are.”


She asks her clients to state their specific goals in wanting to change the portfolio. By understanding to what degree they can tolerate portfolio misbehavior and still be able to achieve their long-term goals, they’ll be better able to ride out the market’s fluctuations. “I tell them that when they feel the impulse to do something, just step away,” she says.

“I think I have a pretty good depth of expertise in the areas of portfolio theory and financial market theory and all of that, but I think of myself first and foremost as a financial planner,” says Yeske. “Financial planning is all about context. A lot of these

behavioral factors and cognitive errors are about inappropriate context, but the financial planning process rescues us every time because it creates that broad context. If it’s done right, financial planning is creating a context that is directly connected to who the clients are as human beings and what their dreams and aspirations are.”

Chris Blunt, executive VP of New York Life Investment Management, points out that advisors themselves will at times fall prey to the same cognitive errors as clients. He points to the Internet bubble as one time when everyone who should have known better, didn’t. “We all made fools of ourselves,” he says. “It wasn’t like it went on for a week. It went on for almost two years. All these really smart people believed that these long-term principles no longer applied.”

These days the message that Blunt tries to bring advisors is that while these behavioral biases exist among their clients, they can be effectively combated by putting a portfolio process into place and having the discipline to adhere to the process. “If you actually believe that the individual investor is driven more by psychology than economics,” he argues, “then the financial advisors, the really good ones, are much more managers of client behavior than economists.

“Good financial advisors often earn their pay through the things that they help their clients not do.” 

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