Strictly Financial

What is Behavioural Finance?

An introduction to the concepts and a discussion of how it is relevant to financial services research (first presented at the MRS Financial Services Conference in 2013)

May 2017

Our insights and observations

Specialist qualitative research for the financial industry

strictlyfinancial.com

The aim of this paper is to provide an introduction to Behavioural Finance, an overview of some of the theory behind it, and some examples of its potential uses.

Behavioural finance is closely related to, but different from, behavioural economics. Originally developed as a way to understand the boom and bust of stock market behaviour, much of the initial thinking and many of the associated theories were technical and impenetrable. However, over time the definition has broadened, and it has now come to mean how individuals and organisations approach and manage their financial activities, and what consequences this has at the individual, corporate, market and social policy levels.

So what is behavioural finance? Wikpedia defines it as '*scientific research on human and social cognitive and emotional biases to better understand economic decisions and how they affect market prices, returns and the allocation of resources*'. It aims to explain and improve understanding of how emotion affects financial behaviour – for example the phenomenon that someone is more inclined to take out travel insurance after someone they know experiences an accident abroad, even though the likelihood of something happening to them has not changed.

In the research world there is continued scepticism about behavioural finance - we have always known that people do not always say what they mean, mean what they say or act as they claim, and we have used our intuition, experience and market knowledge to explain these anomalies – so what could this new discipline add?

The main difference is that behavioural finance gives us a theoretical underpinning to help us understand these disconnects and get to grips with the underlying drivers of financial behaviours.

–

Behavioural Finance helps researchers explain anomalies using a robust and multi-disciplinary approach (psychology, sociology and finance), rather than simply relying on our own gut feel.

–

System 1 and System 2 thinking

Behavioural economics and behavioural finance are often talked about as two different disciplines, but in reality, the distinction between them is very narrow – behavioural finance is essentially how we make, and what influences, our **financial** decisions. Arguably almost any general decision that we make has an element which is influenced by financial context.

Traditionally, standard economics assumes that when people are making (financial) decisions, they collate all the available information, understand and consider all the key concepts, and apply these correctly to come to a logical and strategically sound conclusion (System 2 thinking). So, in this world, everyone reviews their pension funds at least once a year, taking time to examine all the funds on offer across the market in terms of cost and performance, carefully selecting the ones that best meet their retirement objectives, and rebalances their overall portfolio to ensure the ideal spread of risk. Of course we do…

System 1	System 2
Unconscious	Conscious
Automatic	Measured
Rapid	Slow
Associative	Rule based
Low effort	High effort
Intuitive	Logical

In fact we are not always rational – rather, we simply ‘react’ to situations (including financial situations) based on gut feel and intuition (System 1 thinking). Our judgment may be influenced without us even realising it – how many people who bought Royal Mail shares had previously considered investing in the stock market, or had taken the time to look at whether this was the best investment for their circumstances? Or did they just react to the hype?

–

Feeling is an extremely quick way of processing information – we have evolved to ‘act’ without conscious thinking.

–

Irrational decision making is exacerbated in the financial services arena, which is complex, confusing, boring and extremely daunting. The concepts are often unfamiliar, the decision making infrequent, the language (and acronyms) impenetrable, and the mathematics challenging.

Understanding all this information in order to come to a ‘best fit’ conclusion requires rigorous (System 2) thinking which ‘does your head in’. Just think of the amount of literature and information produced by one financial services company about a single product – multiply that by all the available options, and it is no wonder people find it easier to put it off to another day, or simply default to a previous behaviour. I know I should make a will, switch energy supplier or take out a pension, but…

In this paper, we have selected four or five biases and heuristics that are particularly relevant to behavioural finance – however, this is nowhere near an exhaustive list. It is also important to remember that these biases do not work in isolation, and that several may be in play for any given decision.

Optimism bias/ over confidence

We are (generally speaking) optimistic about outcomes – otherwise we would not embark on many projects, and buying lottery tickets would be a thing of the past. At the corporate level, it has led to high profile corporate blunders, doomed corporate acquisitions and claims of foul play.

–

As human beings, we tend to overestimate our own skills and likelihood of success.

–

Underlying this for investors is our failure to learn from our past mistakes. When something goes well, we feel we have made a brilliant decision, and pat ourselves on the back. However, when something fails to perform, we seek alternative explanations for its failure – the market behaved badly, I received poor advice, I wasn't told all the pertinent facts, etc. Therefore, we may repeat the same financial behaviour or continue with a course of action without fully appreciating its potential impact.

Coupled with this is our tendency to underestimate the potential for something to go horribly wrong – 'it will all be okay' or 'we will cut our cloth' is a common refrain when talking to people about their future pension provision – this is either because they believe that something will happen to make it okay, or because people believe that they will behave more sensibly in the future than they are doing now - it is easier to put something off than deal with it now (the cost of delay is less than the cost of action) – I will start my pension next year, I will write my will next year, etc.

Herd behaviour/ social norms

Like it or not, we are heavily influenced by the expectations and behaviour of others – this is a genuine survival technique – think of flocks of birds, shoals of fish or perhaps more relevant to the financial services market, meerkat society. In nature, if one bird changes direction mid-flight the others will automatically follow – if they didn't, in evolutionary terms, they might not survive.

Humans display similar behaviour. The actions of others indicate to us the correct, safest or most advantageous course of action. It is often safer to do as others do than forge our own, untried and untested path.

In the financial world, herding can also imply making decisions based on a single piece of information and ignoring other pertinent information – this means that decisions are made out of context – my Dad took out an endowment 40 years ago and it worked for him, so why wouldn't I do the same now? We also favour information that confirms a hypothesis or is familiar to us, and discount information that runs counter to it. This is how speculative bubbles happen - for example the dotcom boom – and it contributes to false assumptions such as the prevailing belief during the noughties that house prices could never go down.

This is as true for the professionals as it is for the amateur investor – there is often no factual basis for how the market behaves, but rather market rumour creates market runs. Someone starts a move and other people follow, trying to ride the trend. Because financial services are so complex, herding can be used to encourage certain advantageous behaviours – for example, the recent introduction of pensions auto enrolment – I'm In!

Loss aversion or the endowment effect

People do not want to acknowledge that they have made a poor decision, or admit that they have made a loss – it is seen as a sign of weakness to others, and can undermine their self-confidence and self-perception.

–

A loss causes more emotional 'pain' than a similar gain causes pleasure.

–

The pain experienced is twofold:

- Firstly, related to our self-perceptions - people are naturally defensive and reluctant to admit that they have made a mistake. So, to become comfortable with this, we attempt to justify or rationalise our choices, or we change our investment styles to support our financial decisions. This aspect explains why investors are reluctant to sell poorly performing shares even when every indication is that it would be in their best interests to do so – they want to cling to a belief even when faced with evidence to the contrary. How traders (and companies) handle losses can make or break an account. This inability to accept a loss can wipe out an otherwise successful trading account, because the trader continues to pour good money after bad, or clings to a position eventually realising a much greater loss than if they had cut and run much earlier.
- Secondly, the emotional pain of making a loss. Showing a 'paper' loss of stock value is a very different prospect from crystalising that loss in hard cash – this can directly affect trading volumes. For example, trading activity on the Japanese stock market fell by over 80% between late 1980s and mid 90s, as people sat on their investments in the hope that their shares would eventually come good again.

This not only affects investments, but can be applied in a wider context to brand and product selection – we prefer to stick with the 'known' rather than the unknown, partly because of the risk of loss. This may go some way to explaining the preference for relatively safe investments – people are in effect 'paying extra' not to experience the pain of loss.

Prospect theory, or anchoring.

People as a rule are pretty bad at maths, and when you begin talking about probabilities, it quickly becomes ‘too difficult’, and people simply can’t cope or give up.

As a result, we find that people tend to use a reference point to help **anchor** and process information – we use what we already know to work out the likelihood of something else happening. A good strategy – but if the information is incorrect, misunderstood or incomplete, or if the anchor used is inappropriate, it can lead to errors.

A first-time buyer over the last few years may have made the assumption that interest rates always bump around 3-5%. Those of us who were around during the 80s experienced interest rates of up to 15%. Therefore our anchor points are totally different.

So how is this relevant? Firstly, people tend to overestimate the probability of something happening if they have recent evidence, threat or memory of it – and this can create temporary demand for certain products or create ‘new norms’ against which people anchor their expectations. Demand for a certain type of insurance is likely to increase after an event irrespective of the probability of that event occurring again – for example, individuals may increase their level of car insurance **after** they have had a prang.

Secondly, it can affect people’s perception of risk. Just watch Deal Or No Deal, and think about the emotional turmoil when someone is faced with a banker’s offer. Do they go for a smaller sure thing, or a less sure, but potentially more profitable option? Most people become risk averse and select the sure thing, even if on the weight of probabilities they would be better off with the riskier choice. The idea of having nothing pushes them towards safety.

Mental accounting

Another important, and well known, activity is mental accounting. The same amount of money may have a different emotional value depending on the source of that money or its designated purpose.

Think about £20 and how you view it. Imagine you have just been given £20 as your wage by your employer – how do you feel about it? Second, you have been given £20 as a Christmas present. And third, you have just found £20 in the street. Most people will think about and use what is effectively the same monetary value very differently.

–

A £20 present carries with it the expectations of the giver, whereas a £20 windfall is yours to fritter as you want.

–

This is a form of ‘jam jarring’ – creating imaginary financial walls, where different pots have different roles and purposes, and are treated differently in terms of accessibility, risk, etc. It also applies to corporates - a strategic project is put on hold because the annual budget has run out, whilst another department within the same organisation is frantically ‘spending’ budget to protect next year’s allocation.

… and there are many more where these came from…

The examples discussed are only the tip of the iceberg when it comes to the biases and heuristics that can affect financial decision making.

The physical and emotional resources that individuals are prepared to commit to the process of managing their finances will ultimately affect their financial preparedness in both the short and long term – the savings and protections gaps are very real issues that the UK government is attempting to redress. How people react to external events at the personal, social and global levels will drive activity – be that buying, or creating a run on specific stocks and shares, or influencing the popularity of and demand for a particular product.

Behavioural Finance thinking goes some way to understanding why people make seemingly irrational financial decisions. Having a framework around which we can structure thinking about these behaviours will ultimately help the industry to help people navigate through what is a challenging and potentially overwhelming sector. Indeed, some investment companies have started offering Behavioural Finance personality tools to their customers to help them identify and counter these biases in their behaviour.