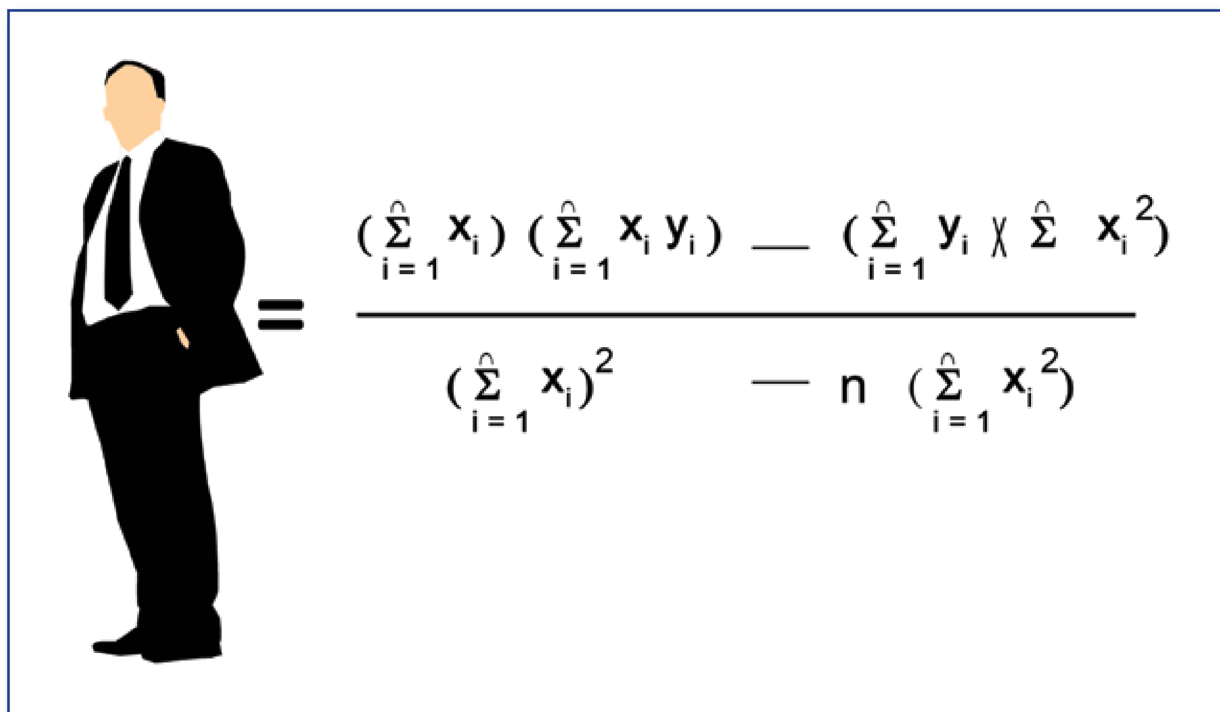
INVESTORS AND THEIR DECISIONS

A series of articles, this one being the 1rst, addressing investors and their decisions. In particular, whether other factors than rational considerations play a role in the investment decision process, and if so, what the practical consequences and applications are for investors. We will start with the concept of the "Homo Economicus", the backbone for the notion that investors make decisions rationally, and its challenges.

"HOMO ECONOMICUS"?



note (1)

The notion that investors make decisions not just rationally but for many other reasons may come across as "stating the obvious". Is not that just what we humans are about: subjective, flawed by biases, capable of extraordinary intelligence as well as astounding stupidity, gifted as well as restricted? Do not we see in the smaller as well as the bigger decisions made day-to-day by ourselves as well as by people in the limelight (be it politicians or celebrities) that decisions are not just made rationally?

In fact, whether we humans are rational beings, yes or no and to what extent, has been a central topic in philosophy for as long as the records go back. And it seems that what view prevails is like a tipping scale, whose balance varies. On the one end of the scale the view that we humans are largely driven by animal instincts (central in Sigmund Freud's theory) and on the other end the view that we are rational beings (put forward by Descartes, Adam Smith and others).

The idea that we are rational beings is central in many *economic* theories, captured in the term "HOMO ECONOMICUS"[(2)]: humans are rational and self-interested actors who have the ability to make judgments toward their subjectively defined ends. People seek to attain very specific and pre-determined goals to the greatest extent with the least possible cost.

The “self-interest part” is well put forward in the following simple example given by Adam Smith[3]: “it is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner but from the regard to their own interest”. In these articles I will focus more on the “rational decision making” characteristics of the homo economicus.

So, in a way, it is understandable when viewing investing as an “economic activity” that it was the science of economy that started to make assumptions about investor behaviour rather than the science of psychology; and that this assumption became “the homo economicus”. So, the assumption was made that investors make their decisions rationally. And this notion nicely ties in with the idea that financial markets are rational and efficient, as put forward by the efficient market hypothesis [4].

In finance, the efficient-market hypothesis (EMH) asserts that financial markets are “informationally efficient”. According to the EMH, stocks always trade at their fair value on stock exchanges, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices [5].

Note: In consequence of this, one cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis, given the information available at the time the investment is made [6].

There was only one problem: markets do not always behave rationally and neither are they always efficient…There are several examples of this; for now let’s just recognize the phenomenon of stock market bubbles and crashes.

So, for this reason, we may understand why the following, key question has come up when it comes to investors and the decisions they make [7]:

“Why do market participants make systematic errors (when they are not supposed to)? Such errors affect prices and returns and create market inefficiencies?”

Aiming to answering this question has become the domain of behavioural finance, which combines the sciences of economics and psychology [8]. Behavioural finance challenges the assumption of the Homo economicus and states that investors in their decision making processes are prone to biases. Biases which cloud the rational process. Two types of biases are generally recognized [9]:

1) **Cognitive Biases.** An example being the “over confidence factor”. A range of experiments show that we tend to attribute too much weight to our investment skills when we made a good investment decision, leading to errors in subsequent investment decisions;

2) **Emotional Biases.** An example being Regret Aversion: investors may hold on to a losing stock (when better choices are available) to avoid regret.

Note: I will review these biases more in detail in the following articles.

We can apply perspectives outside behavioural finance, challenging the “homo economicus” notion, and providing explanations (and solutions!) for irrational decision making as well. In fact, there are many. One is currently very much in the limelight, as it is used (with success) in top sports in the UK. This is the “Inner Chimp Paradox Theory”, put forward by Dr. Peters [10]. The practical application of this theory (and with Peters active assistance) has helped among others Chris Hoy, Victoria Pendleton and Bradley Wiggins gaining their gold medals. Peters is firmly in the “Freud tradition” (like Freud was, he is a psychiater). The essence of his theory is that part of our brains is “animal wired”, best to be compared to that of a chimpanzee. And that this part of the brain responds 5 times faster to any situation than the human (more rational) part of our brains. The key is to manage this “chimp part”. If Chris Hoy, Bradley Wiggins and other top athletes benefitted from this model and its application, how could investors?

Both adherents to behavioural finance [11] as well as people like Dr. Steve Peters, come from very practical perspectives to the conclusion that self awareness in decision making is key. So, interesting enough, investors whose motive for investing is to make money work, are invited to take a journey in self awareness as well. Of course that is, if indeed they come to the conclusion that investing is not just a rational process. Readers can make up their own minds about that. In the next articles I will cover a range of biases investors are prone too.

Notes:
(1): inspired by artist Antruejo,www.toonpool.com
(2),(3),(4),(6),(7),(8): Wikipedia
(5): Investopedia
(9): Jay Mooreland: How Biases influence our Investment decisions. Journal of Financial Planning
(10): Dr. Steve Peters: The Mind Management, Vermillion, London, 2011
(11): Doug Lennick in Moral Intelligence and the Value of Behavioral Advice. Journal of Financial Planning

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