New Research on Investor Behavior
By C. Thomas Howard, PhD
April 2, 2013

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

Market theory passed through two distinctly different paradigms in the past 80 years and is experiencing the rise of a third. Those transitions have marked the introduction of improved ways to explain price movements. The ascendant paradigm, based on new research in the field of behavioral economics, promises to offer superior guidance to investors and advisors who hope to exploit market inefficiencies.

The first paradigm was launched in 1934 with Graham and Dodd’s (GD) Securities Analysis, which provided the first systematic approach to analyzing and investing in stocks. GD argued that it was possible to build superior stock portfolios using careful fundamental analysis and a set of simple decision rules. These rules were based on the emotional mistakes made by the market that could be identified via fundamental analysis. The success of GD is all the more impressive because their book appeared in the depths of the Great Depression, when stocks were crashing and market volatility was reaching levels not seen before nor since.

GD’s dominance lasted 40 years, until the ascendency of modern portfolio theory (MPT) in the mid-1970s. MPT agreed that there were many emotional investors, but there were enough rational investors to arbitrage away pricing mistakes. Therefore market prices were “informationally efficient.” A consequence of this theory was that it was not worth conducting a GD-type of analysis, or any analysis for that matter. Instead, an investor should simply buy and hold an index portfolio.

MPT immediately ran into problems with the publication of two studies: Sanjay Basu’s study demonstrating that stocks with low price-to-earnings ratios outperformed high PE stocks and Rolf Banz’s study demonstrating that small stocks outperformed large stocks. MPT had no answer for these anomalies. In order to save the model, the two were sucked into MPT as “return factors.” It has been downhill for MPT ever since, with study after study uncovering one anomaly after another.

As MPT rose to prominence, a parallel research stream explored how individuals actually made decisions. The conclusion of this behavioral science research was that emotions and heuristics dominate decision-making. It is amazing how little rationality was uncovered in these studies!

© Copyright 2013, Advisor Perspectives, Inc. All rights reserved.
Because of the many problems facing MPT and the growing awareness of the provocative behavioral science results, we are currently witnessing the decline of MPT and the rise of behavioral finance. Among other things, this transition brings back Graham and Dodd as an important way to avoid emotional investment decisions and analyze the market’s faulty pricing mechanism.

**Introducing behavioral portfolio management**

Successful investing is emotionally difficult. It often requires waiting for long-term results when your portfolio was recently pummeled, recommending an investment when others think it is a dog, investing when volatility is high and, in general, looking and acting different from the crowd. To be a successful investor, you must make a conscious decision to redirect your natural impulses and focus on careful and thoughtful analysis. Staying disciplined in an emotionally charged, 24-hour-news-cycle world is a challenge.

Behavioral portfolio management (BPM) assumes that most investors make decisions based on emotions and shortcut heuristics. It posits that there are two categories of financial market participants: emotional crowds and behavioral data investors (BDIs). Emotional crowds are made up of investors who base decisions on anecdotal evidence and emotional reactions to unfolding events. Human evolution hardwires us for short-term loss aversion and social validation, which are the underlying drivers of today’s emotional crowds.

Emotional investors make their decisions based on what Daniel Kahneman (*Thinking, Fast and Slow*, 2012) refers to as System 1 thinking: automatic, loss-avoiding and quick, with little or no effort and no sense of voluntary control. On the other hand, BDIs make their decisions using thorough and extensive analysis of available data. BDIs use what Kahneman refers to as System 2 thinking: effortful, high-concentration and complex. BPM is built on the dynamic interplay between these two investor groups.

MPT is the prevailing theory of financial markets. It posits that even though there are numerous irrational investors, rational investors quickly arbitrage away any price distortions. This implies that prices fully reflect all relevant information, that active investing lacks excess returns and that indexed portfolios are superior to their actively managed counterparts. In short, MPT contends that rational investors dominate the financial pricing process.

But what if it is the other way around? That is, what if emotional investors dominate? If this were the case, then price distortions would be common and could be used to build portfolios that are superior to the corresponding index. Active management could generate superior returns. In fact, we would see the impact of emotions in every corner of the...
market, and they would have to be taken into account when managing investment portfolios.

There is now ample evidence, which I will review in a subsequent article, supporting the argument that emotional crowds dominate market pricing and volatility. Emotional crowds drive prices based on the latest pessimistic or optimistic scenarios. Because stock trading is virtually free, there is little natural resistance to stocks moving dramatically in one direction or the other, amplifying these price movements. The market’s mantra is: “If anything is worth doing, it is worth overdoing.”

Rational investors, or what I call BDIs, react to the resulting distortions by taking positions opposite the emotional crowd. But they are not of sufficient heft to keep prices in line. As a consequence, the resulting distortions are measurable and persistent. BDIs are able to build portfolios that take advantage of these distortions as they are eventually corrected by the market, either rationally or simply because the crowd is now moving in another direction.

The events that trigger crowd responses may be short lived, but the subsequent emotions are long-lasting. As a result, price distortions are both measurable and persistent. This provides BDIs an opportunity to identify distortions and build portfolios benefiting from them. Even though a BDI portfolio will outperform, building such a portfolio is emotionally difficult, because the BDI is forever going against the crowd. The need for social validation acts as a powerful deterrent for most investors. Given the difficulty of behavior modification, there is little reason to believe that this situation will change any time soon. So BPM contends that BDIs will have a return advantage relative to crowds into the foreseeable future.

Viewing the world through the lens of BPM reveals that the decisions made by market professionals are often based on faulty emotional analysis. It appears that much of what passes as professional analytics and due diligence is a way to rationalize emotional decision-making.

Implementing BPM: Redirect, harness, mitigate

Over the coming weeks I will present, in a series of Advisor Perspectives articles, my thoughts on how advisors and investment managers can successfully implement BPM. I propose three BPM basic principles, which will be the focus of the articles that follow.

When implementing BPM, it is necessary for the advisor and investment manager to focus on three tasks: redirect your own emotions, harness the market’s emotions and mitigate the impact of client emotions. The articles that follow will explore how you can be successful in each of these emotional dimensions.
The table below is the framework I will use in discussing these issues. The higher you rank on each of these three scales, the more successful you will be in implementing BPM. I will provide specific ideas in each area drawn from my 30-plus years of teaching, research and hands-on portfolio management, as well as from a growing body of behavioral and financial research.

Implementing Behavioral Portfolio Management

Redirect your own emotions
Harness the market’s emotions
Mitigate the impact of client emotions

<table>
<thead>
<tr>
<th>Behavioral Data Investor</th>
<th>Mitigating</th>
</tr>
</thead>
<tbody>
<tr>
<td>50/50</td>
<td>50/50</td>
</tr>
<tr>
<td>Emotional Crowd</td>
<td>Catering</td>
</tr>
<tr>
<td>Redirect</td>
<td>Harness</td>
</tr>
</tbody>
</table>

C. Thomas Howard is Professor Emeritus, Reiman School of Finance, Daniels College of Business, University of Denver and CEO and Director of Research, Athenainvest, Inc. Contact information: tom.howard@athenainvest.com  (877) 430-5675 x100. A longer version of Behavioral Portfolio Management can be obtained at the Social Sciences Research Network website.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit: http://www.advisorperspectives.com/subscribers/subscribe.php

© Copyright 2013, Advisor Perspectives, Inc. All rights reserved.