



FEATURE ARTICLE

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The Psychology of Investing

As I am sure you are all aware behavioural finance is a relatively new area of study that explores how emotional and psychological factors effect investment decisions.

Much of traditional financial theory is based on the assumption that individuals act rationally and consider all available information when making investment decisions. Behavioural finance challenges this and looks at various potential reasons why individuals may reach inappropriate conclusions and take the "wrong" action, even if the information they are given is correct.

Prospect Theory/Loss Aversion:

Probably the best known theory in the area of behavioural finance is prospect theory.

This attempts to explain why individuals do not always behave rationally when faced with either accumulated gains or losses which have not been realised. According to this theory individuals will be much more distressed by losses than they are happy with the equivalent gains. Thus individuals respond differently to equivalent situations depending on whether they are faced with a loss or a gain.

Prospect theory/loss aversion states that generally individuals "play safe" when protecting gains but if they are faced with the possibility of losing money they often take riskier decisions aimed at loss aversion - this may take the form of a reluctance to realise paper losses meaning individuals hold on to losing investments longer than perhaps they should in the hope that given time they will recoup the loss (sadly I have certainly been guilty of this!).

The theory postulates that individuals tend to feel sorrow and grief after having made an error of judgement and avoid selling investments that have gone down in value in order to avoid the pain and regret of having made a bad investment. Some behavioural finance proponents argue that investors typically consider the loss of £1 twice as painful as the pleasure received from a £1 gain.



It is therefore, if you believe in behavioural finance, prospect theory/loss aversion which causes certain investors to hold losing positions too long in the hope that they will recoup their losses or alternatively sell certain investments too soon to lock in profits in case they turn into losses.

Overconfidence

Another behavioural finance concept/theory is overconfidence.

This area of behavioural finance states that individuals have a tendency to overestimate their own skills and predictions for success and underestimate the potential for failure over which they have no control.

In simple terms overconfidence means that investors tend to be more optimistic when markets are going up and more pessimistic when markets are falling. Which is of course the basis for the famous quote from Warren Buffett that one should, "Be fearful when others are greedy and greedy when others are fearful."

Recency Bias

Your rugby team has lost five consecutive matches. Heads need to roll!

Behavioural finance says that we weight recent events more in our mind, even if they don't deserve it. Certain investors thrive on recency bias, they rely on looking through the rear view mirror, engaging in what the psychologists call "recency bias." They assume, for example, that because 2011 was a tough year for the world's stock markets, 2012 will be just as bad. But the financial world doesn't work that way.

As an investor you should generally try to look a couple of years into the future but that can be difficult when living in an uncertain present.

Ultimately you'd be crazy to drive your car whilst spending all of your time looking at where you've come from. Recency bias says that you should try to avoid doing so with your investments but instead keep an eye both on the past and the future.

Ultimately as the FSA is so keen for us to confirm to clients, the past is no guarantee of the future.

Herd instinct

Finally in this short article on the psychology of investing it would be remiss of me not to mention herd instinct/behaviour.



If you look on Wikipedia it says that herd instinct is "... human conduct during activities such as stock market bubbles and crashes, street demonstrations, sporting events, religious gatherings, episodes of mob violence and everyday decision-making, judgment and opinion-forming."

The fact is that we are all drawn to safety in numbers, even if that safety doesn't in fact exist. It is easier psychologically to follow the herd rather than run against it but the fact is that the herd isn't always right and sometimes it pays to think outside the box - which again takes us back to the Warren Buffett quote that I mentioned earlier.

So how do individuals avoid these pitfalls?

Ultimately many behavioural finance theories are based on the assumption of directly managing one's own money and if this part of the equation is withdrawn then the investment decisions made potentially become much better.

Choices for such dispassionate professional management include various fund of funds or discretionary managers linked to an appropriate risk profile/asset allocation although of course the choice of the "right" one is where an Independent Financial Adviser can be invaluable.

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