How decisions are made:
lessons from behavioural finance

Paul Craven,
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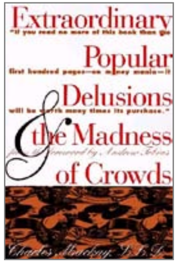
Goldman Sachs Asset Management

The Wisdom of Crowds?

Behavioural finance seeks to explain the **psychology of markets** and **groups of people**

- The relationship between prices and people
- Irrational behaviour – greed, fear, emotional motivation?
- The herd instinct?

Are crowds 'mad' ……………. or 'wise'?



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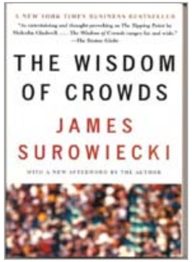

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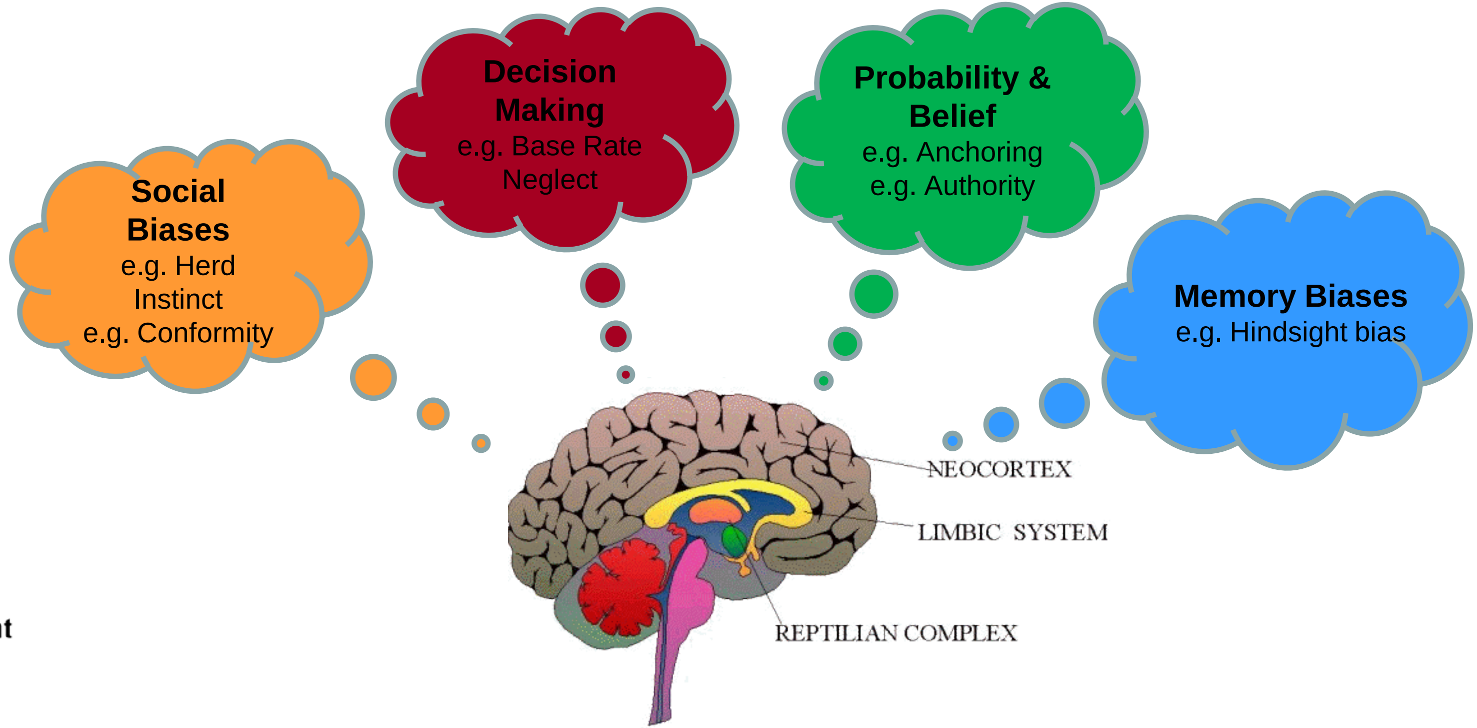
Cognitive Biases – ‘Mental Shortcuts’



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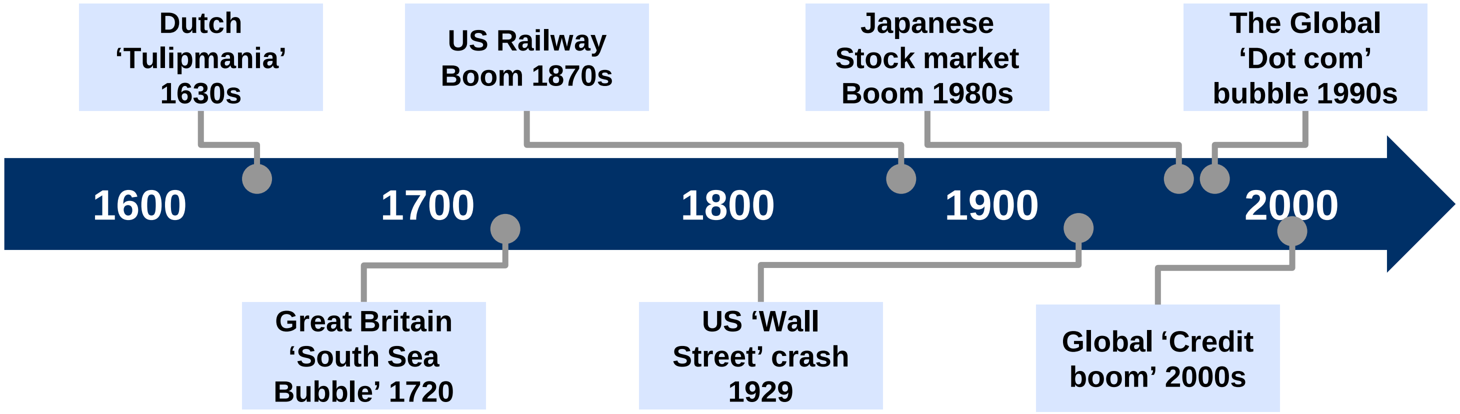
Five Behavioural Biases

1. Herd Instinct – ‘Information cascades’

- You observe other’s actions before you make your own decision
- An ‘**information cascade**’ arises if it becomes optimal to ignore your own information in favour of the (inferred) information of others



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Source: GSAM

2. Conformity
The Asch experiment

- In the 1950s, Solomon Asch developed a series of experiments examining whether perception could be influenced by social pressure.
- Asch showed cards with pictures like this to groups of 8 to 10 college students:

- The subject was told he was studying visual perception – his task was to decide which of the bars on the right was the same length as the one on the left.
- (All the other students voted the same way for a wrong answer before the subject gave his answer).

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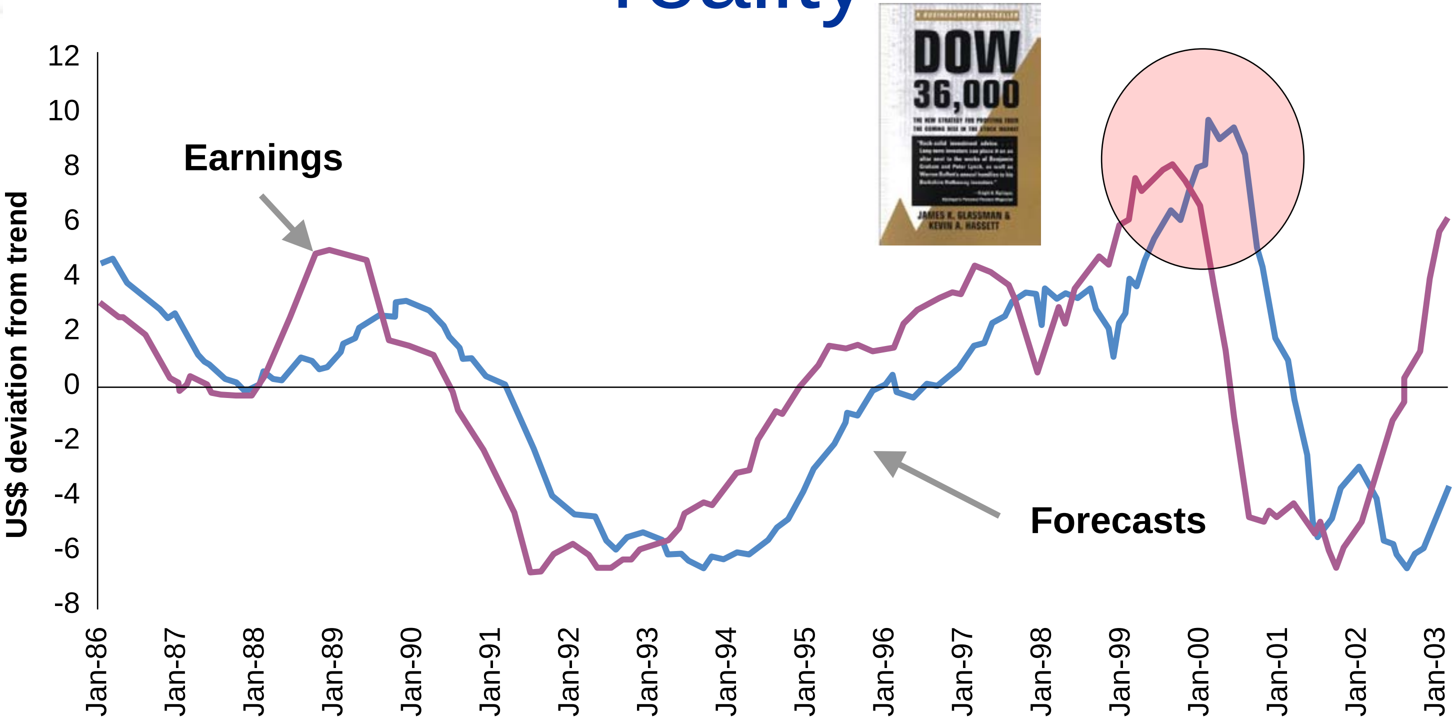
"Kites rise highest against the wind – not with it" (Churchill)

3. Anchoring – analysts lag reality



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Source: GMO. This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice.

4. Authority
The Milgram experiment

- One of the best known experiments in social psychology is that of **Milgram** (1961).
- In this set of experiments, carried out at Yale in the early 1960s, Milgram studied the influence of ‘**authority**’ on decision making.

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Source: Milgram.

5.'Base Rate Neglect'

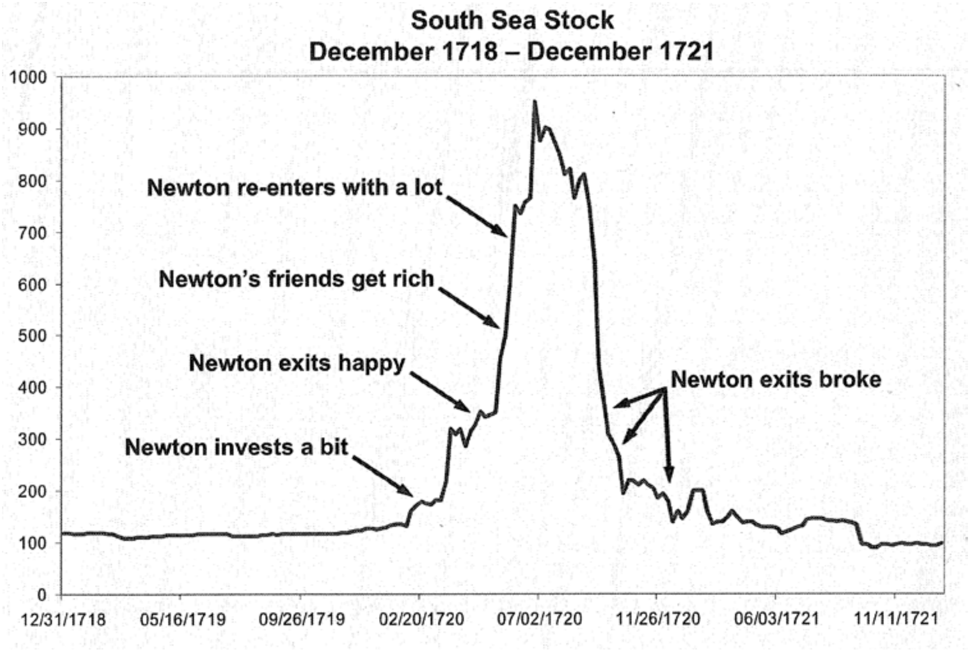
Stories:

- Are universal, crossing boundaries of language, culture and age – sense of continuity
- Mirror human thought (we think in narrative structures e.g. past, present, future)
- Define who we are (easier to identify with an individual than a 'statistically average person')

Stories generate emotion!

Source: Loick Roche, John Sadowskey, The Power of Stories, International Fund of IT and Management 2003.

Sir Isaac Newton liked the South Sea story and rejoined the herd…



The herd instinct, conformity, anchoring and the power of stories…

Source: Marc Faber, The Gloom, Boom & Doom Report.

Conclusions

Recognising your biases should allow you, to be a more effective decision maker

These include *'mental shortcuts'* such as:

1. the **herd instinct**
2. the influence of **conformity**
3. **Anchoring**
4. the influence of **authority**
5. the power of **stories**

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"I can calculate the motion of heavenly bodies, but not the madness of people…" (Sir Isaac Newton).

Exploring Behavioural biases at work

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Markets and decision making

"In the short-run, the market is a voting machine but in the long run, the market is a weighing machine".

(Benjamin Graham 1894–1976)

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Wise Crowds- combat ‘groupthink’

Making sure the right people are involved	• Ensure the are a diversity of backgrounds, roles, interests and personality types.
Assign homework	• Due diligence based on independent facts.
Create the right atmosphere	• Encourage all members to speak up and have a ‘Devils Advocate’
Manage the debate	• Set an agenda, devise a voting system, have clear goals and review your process regularly
Follow up	• Commit yourself to the decision and communicate them to the group.

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Source: McKinsey Quarterly, 2010.

“Winning the Loser’s Game” Investment lessons from sport

Golf: “The way to win is by making fewer bad shots…” (Tommy Armour)

Tennis: “The victor in a game of tennis gets a higher score than the opponent, but he gets the higher score because his opponent is losing even more points.” (Charles D. Ellis)

- Play your own game
- Keep it simple
- Concentrate on your defences
- Don’t take it personally

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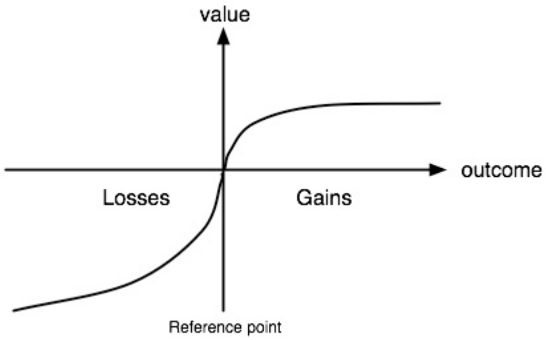
**This can apply to waging war,
campaigning for office, flying a plane…and investment**

Source: The Loser’s Game, Charles Ellis, financial Analysts Journal, July 1975
http://www.ifa.com/pdf/EllisCharlesThe_Loser's_Game1975.pdf

Prospect Theory

- Tendency to prefer avoiding losses than acquiring gains
- Risk aversion, sunk cost and endowment effects
- Important consequences for marketing e.g. price framing



Investors tend to hold on to losing stocks too long and sell winning stocks too soon.

Source: Kahneman, Tversky ‘Prospect Theory,’ 1979.

Biography

Paul Craven

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Paul is head of EMEA Institutional Business. He joined Goldman Sachs Asset Management in 2007 as a managing director. Prior to joining the firm, Paul worked at PIMCO Europe Ltd for four years, where he was head of UK Business Development. Previously, he spent seventeen years at Schroders as a portfolio manager and latterly as head of UK Institutional Sales. Paul has an MA (Hons) in History from St. John's College, Cambridge University and is a member of the CFA Institute, the UK Society of Investment Professionals and the Magic Circle

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