The BhFS Way: Investment Advising from the Psychological Perspective

Psychological Risk Management

Every investor knows that without taking risk, attractive returns are not achievable. For this reason a modern risk manager should make it possible to control risk through diversification and hedging strategies. Research of psychological risk reveals two types of mistakes in risk management made by private investors. On one side, psychological research shows which psychological traps investors fall into causing them to take unnecessary risk. On the other side, the research demonstrates which types of risk investors fear. If one has a misunderstanding of the risks investors care about, then precisely these risks may be left unmanaged in a portfolio.

The Ten most Common Investment Mistakes

1. "You may delay, but time will not" – Benjamin Franklin
   Many investors feel that investing is a very challenging task, and continually put it off. It is put off to the next time, and again to the next time, until they eventually become aware that a big portion of the return opportunities have gone because they didn't take the time to make investment decisions.

2. "This week was sunny, so tomorrow I leave my umbrella at home"
   If stocks have granted good returns for a few years, many investors will invest again in the stock market. They are so focused on attractive returns that they overestimate their risk tolerance. They have forgotten how much nerve it takes to stay invested in the stock market during a downturn. A rude awakening is sooner or latter inevitable.

3. "Betting on the winner who already won"
   People are "adaptive learners" according to psychology. Practically, this means: if something gives us success we will be inclined to do it again. Only with failure do we change our behaviour. Unfortunately this strategy is not useful in the financial markets. Whoever follows the masses and holds the investments which have until now been successful, has a slim chance of winning returns, and is not invested when the biggest winnings are available. Although difficult considering our innate "herd instinct," successful investors like the American investment guru Warren Buffet remain anti-cyclical and refrain from running with the herd.

4. "Market prices disclose all"
   To analyze the fluctuation of market prices can be fascinating, but this effort is not profitable. The fluctuation of asset prices does not on its own hold any valuable information, contrary to the indications of numerous business studies. The study of price fluctuations reveals that investors too quickly believe a market move is a trend,

and too quickly pull out of profitable investments, because they are afraid that "the end" is near.

5. "Always staying on the ball"
   Psychological research shows that the more often one looks at the progress of a risky investment, the less and less inclined one is to remain invested. A risky investment does not only move upwards. Psychologically, losses hurt more than gains make one happy. For this reason, those who look too often at their investment cannot endure the fluctuations. They forget that the probability of realizing a loss on the financial market decreases as the investment time horizon increases. For this reason investors give up a large portion of the long term returns available to them.

6. "The odd charm of losers"
   Private investors too quickly cash-in on short term winners and wait out losers for too long. If they make an investment decision, then the subsequent decision is not made with consideration for the future, but rather made with consideration only for the past. After a win the investor cashes out of the market and is proud to show off that his initial investment strategy was successful. The opposite is true in the case of a loss. To avoid accepting a loss investors wait in the hope that the investment can redeem itself.

7. "Glitz and Glamour"
   Exciting stories advertise themselves better as boring. This is true in the financial market just like in media. Investors prefer to invest in 'exciting' ideas, for example in fascinating new technology, than to invest in well known ideas. However, in the long term, the economic results of the 'boring stories' prove them to be desirable solid investments. This phenomenon, the so-called value anomaly, has been known in science for more than a hundred years, and can be observed in almost every region of the world.

8. "Better 3 possible good stocks than 100 underperforming stocks"
   The above quote appears to be plausible but is wrong from a scientific point of view. A broad diversification is worthwhile. It is enormously difficult to forecast which stocks or investment funds will be good or bad in the future. For this reason it is worthwhile to spread out the risk. Many studies have shown that private investors are significantly under-diversified. They distrust stocks from other countries, and limit themselves too strongly to their home market. In this way they forgo a large portion of the return opportunities.

9. "Gone with the Wind"
   Many investors feel that they can pilot the investment process themselves. Too often the result is an unclear strategy. Like a leaf in the wind, investors move back and forth. They change their portfolio too often by buying and selling, so that they pay a great deal in transaction fees. This behaviour is of course good for the bank's wallet, but consider 'back and forth makes the wallet empty.

10. "I actually knew that"
It is said in old wives tales that one learns through mistakes. This is not always true. To the contrary: when one experiences a financial mistake resulting in loss, it is a natural reaction to forget why the investment was a mistake. In retrospect many tell themselves that they actually knew what the right investment strategy was, but for some dumb reason they didn't do it. This recurring phenomenon prevents us from learning from our mistakes.

Risk in the Psychological Perspective

It is how Benjamin Graham already in the 20th century said: "The investor's chief problem and even his worst enemy is likely to be himself."? Not only! In the addition to the psychological traps, the risk that most modern risk management is based on is for investors the wrong one to control. This has been the situation since 1952 when Harry Markowitz introduced volatility, the most commonly used risk measure, and in fact a risk measure that is inappropriate for many investors. Volatility measures the average quadratic deviation of a random variable around its mean. Volatility is an appropriate measure of risk only when the returns of all types of investments are normally distributed. For many asset classes (bonds, stocks) this assumption is a bad approximation, and for alternative investments (commodities, hedge funds, real estate) absolutely wrong. If one uses volatility as a measure of risk, the recommended allocation of an alternative investment is for most investors too high. The use of volatility as a risk measure results in an underestimation of the risk of extreme events.

What alternative to volatility has the research of psychological risk brought forth? Firstly, psychological risk research stresses that most investors have a concrete investment goal for their portfolio. When this goal is not met, they feel a loss. A return above their goal is a win. Unlike volatility, investors do not experience winning and losing symmetrically. Most investors react more than twice as strongly to losses then to winnings. In order to accept a 50% chance of loosing 100'000 CHF, the remaining 50% chance must be for a win of at least 200'000 CHF. Without a concrete investment goal most investors willingly pay a relatively large amount to protect their capital. Pre-made structured products with capital protection are based upon this observation. From the psychological perspective, aversion to losses is more important than aversion to volatility, which in the industry is still synonymous with risk aversion. In fact, Kahneman and Tversky say that while experiencing losses, some investors can be risk-loving. That is to say, before one accepts a definite loss, one takes more risk for a chance to get out of the loss zone.

Another important consequence of loss aversion is that for a moderate level of loss, the amount of loss is in fact less important than the probability of loss in the psychological perspective. For extremely loss averse investors this perspective leads to

Roy's risk management principal, where it is described as Safety First. For the minimum tolerable return of a portfolio, the probability is minimized. On the other hand, if an investor doesn't have a clear return goal and breaths in relieve with every growth in performance, as is true for constant risk averse investors, results from psychological research lead back to the Markowitz criteria for volatility minimization. Psychological risk research offers a wide spectrum of risk attitudes, so that both the Safety First principal and the principal of Markowitz are included as special cases. In this way, the implementation of psychological research allows the satisfaction of many types of investors.

Investing with a Plan

The most essential element in investing is to use a systematic approach. The investment advisor must clearly identify the risk aversion, risk preferences, and risk perspective of the investor, and in this way use a psychologically justified risk concept. To meet this goal a risk profiling questionnaire is indispensable. Not only does it identify the starting position of the investor, but also makes the investor more familiar with the trade-offs of the financial market. As investors typically have several investment goals, investments should be structured based on these goals. Next, the results of the questionnaire must lead into a long-term investment strategy that will reflect the risk characteristics of the investor. Finally, the investment strategy must be filled with concrete funds that investors can identify with. This increases their commitment to the strategy, which is especially important during market downturns.

BhFS
Behavioural Finance Solutions GmbH
c/o University of Zurich
Plattenstrasse 32
8032 Zürich – Switzerland

Phone: +41 (0)44 634 48 25
Website: www.bhfs.ch
Email: info@bhfs.ch