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## Paging Dr. Freud

*Man is made for error; it enters his mind naturally and he discovers a few truths only with the greatest effort –*  
Fredrick the Great

There is a burgeoning field of study in economics called Behavioral Finance. Although it has been around since the 1960's, it has gained additional traction as of late in an effort to explain market volatility. Classic economic theory hypothesizes that individuals will pursue a course of action that provides them with the highest level of utility (maximize benefits). Classic theory assumes that people always act in their own self interest in a cool, rational manner. Behavior, however, is rarely constrained by textbook theory.

A recent Morningstar research paper compared performance of the 9 different stock mutual fund categories that it tracks. It compared the actual average 10 year performance (through May 31st of this year) of each of these categories to the performance that the average investor received in each of the 9 categories. To get at the performance that the average investor received, Morningstar tracked the flows of money into and out of each category over the 10 year period. The average investor *underperformed all 9 category averages*. The underperformance ranged from .35% to 3.33% per year with an average underperformance for all 9 categories of 1.48%. In other words, the average investor surrendered about 1.5% of return per year by making moves clearly *not* in his own self interest. That amounts to \$16,000 less on a \$100,000 investment, or 16% over that time.

In an attempt to explain such irrational behavior, a number of theories have been developed. **Bounded rationality** suggests that rationality of individuals is limited by the information they have, the cognitive limitations of their minds, and the finite amount of time they have to make decisions. It identifies the concept of *rationality as optimization*. Bounded rationality theorizes that because we lack the ability and resources to arrive at the optimal solution, we instead apply reason only after having greatly simplified the choices available, thereby seeking a satisfactory solution rather than the best one (“I guess I’ll have the #3 value meal”).

Given two similar rewards, humans show a preference for one that arrives sooner rather than later. **Hyperbolic discounting** is a mathematical model thought to approximate this discounting process; that is, it models how humans actually make such valuations. Humans are said to *discount* the value of the later reward, by a factor that increases with the length of the delay. In other words, we hate to wait.

We also fall into the trap of **Anchoring** which is a common human tendency to rely too heavily, or *anchor* on one trait or piece of information when making decisions. The trick is to evaluate new information to determine if it represents an aberration, or a trend that indicates a new course of action is warranted.

**Herding** is the tendency for large numbers of people to act the same way at the same time (the Morningstar report indicates that the second fastest growing Exchange Traded Fund this year is GLD – a fund that invests in gold). The tricky part is to turn with the herd or risk getting trampled, or fodder for the lions.

There are hundreds of other theories that attempt to explain the complexities and foibles of the human brain. The bottom line is that both Classic Economic theory and Behavioral Finance theory coexist in financial markets. The difference between the two is elucidated by the time horizon you apply. In the short term Behavioral models dominate. In the long run Classic models, based on the rational deployment of capital, rule the day. As such, we will continue to add Behavioral investment strategies that will keep us in the game while waiting for Classic investment strategies to move us down the field.