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## Article Archive

**Behavioural Finance**

by *Alan Cranfield*

Investing strategy ought to be a perfectly rational action, characterized by careful decision-making and prodigious research. And it is, most of the time, but it's also true that many investment decisions are made out of pure emotion. So many decisions have been made that way that an entire psychological discipline has grown up around the notion of how people make wrong financial decisions. It's called Behavioural Finance.

Behavioural Finance is a discipline that was started by two Israeli psychologists, Daniel Kahneman and Amos Tversky. Kahneman was awarded the Nobel Prize in economics in 2002, despite the fact that he says he's never taken a single course in economics in his life. Tversky would most likely have shared the Nobel award had he not died in 1996.

What the two psychologists wanted to learn was not what the most rational decision-making process was, but rather what the likeliest decision-making process was—not how people should act, but how they actually do act. They conducted a series of experiments looking for ways that people short-circuited what they knew was right, even contradicting the hallowed mantra of "buy low, sell high."

**Key Findings**

This is some of the most important research in the entire field of finance. After all, if you want to make the right choices, it is vital to understand what causes people to make the wrong choices. Here are some of the key findings that Behavioural Finance has come up with:

- We have an inclination to get greedy and buy more when the markets are rising, shoving "buy low, sell high" out the window. By the same token, when the market is in a downturn, we panic and sell too quickly when prices are low.
- When the price of a can of tuna rises, we start shopping for an alternative. But we treat our financial assets differently from consumer goods. When the price of a stock rises, we can't buy enough of it.
- We are more interested in reducing our losses than in taking a chance on a large gain. One experiment offered people the choice between an 80 percent chance of losing $4,000 and a 20 percent chance of breaking even, versus a 100 percent chance of losing $3,000. Not surprisingly, 92 percent of the respondents took the gamble, even though the loss averaged $3,200 against the guaranteed $3,000 loss.
- On the other side of the coin, when people had to choose between an 80 percent chance of winning $4,000 versus a 100 percent chance of winning $3,000, some 80 percent took the guaranteed money.
- The first major loss we suffer is more painful than a subsequent loss of the same amount. In other words, it's very trying to lose $1,000 in the market, but once you've done that, it's not as bad to lose the next $1,000.
- In another psychological experiment, people changed their risk tolerance based solely on whether the question was worded positively. If you ask someone if they want to invest in a stock that has a 35 percent chance of declining, they'll react differently than if you told them about a stock with a 65 percent chance of appreciating.
- Finally, many investors have a great deal more confidence in their abilities to pick

stocks than is warranted by the results.

**Behind the Research**

This is the first in a series of newsletters that will examine the findings of Behavioural Finance. Subsequent articles will examine many studies in more depth to learn why investors behave the way they do and how a trusted advisor and a disciplined process can help investors avoid the most common pitfalls.

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