

Are you Rational or Irrational?

We would all like to think that we are rational when it comes to investing, nevertheless there is evidence to suggest that we can be irrational at times. In Finance there are Conventional theories such as the Efficient Market Hypothesis, which are based on the belief that individuals behave in a rational manner and that share prices always include and reflect all relevant information. However, academics in both finance and economics were not always able to explain certain irregularities in the market using these conventional theories and as such proposed psychology-based theories to explain stock market anomalies. These theories represent the field of Behavioral Finance, which are not meant to replace the conventional theories but are rather complementary and help provide a broader understanding of stock market performances.

There are approximately eight concepts in the field of behavioral finance; however in this article three of the key concepts will be explored so as to illustrate ways in which we sometimes behave in an irrational manner.

Anchoring

This concept illustrates the tendency of individuals to attach or “anchor” thoughts to a reference point which may or may not have logical relevance to the decision at hand. An example of this in everyday life would be: ‘a friend asks how much you paid for your two bedroom apartment, and then ask how much a three bedroom apartment would cost in the same area. If you make an estimate by adding a little more to what you paid even if you have no idea of the actual cost you would be anchoring your estimate onto what you paid for your apartment.’

In terms of investing, an example of anchoring would be an investor holding on to an investment that is losing value because the investor is waiting for the stock to return to a previous price. For instance, let’s say a company’s earnings increase by 40 per cent and as such its share price jumps from \$40 to \$55. However, after the impressive results, one of the company’s major subsidiaries is faced with a challenge and increased costs lead to a 60 per cent fall in earnings from the parent. The change of events results in the share price falling to \$22.

Some investors may have anchored to the high price of \$55 and erroneously believe that the depreciating value was a temporary irregularity in the market. Thus, the investor had anchored the value of the investment to the price it once was instead of selling while the price was yet falling. Also, at the price of \$22 some investors may even believe that the share is undervalued. This is irrational as the intrinsic value or fair market value of the share has changed and as such the investor assumes greater risk by holding it in the hope that it will go back up to the \$55.

To avoid irrelevant anchoring, investors should be very critical when evaluating a stock’s potential. A prudent investor would look at more than one variable or benchmark before making a decision on whether to buy, sell or hold. Also, it is never a bad idea to get different perspectives from other investors, analysts or even your broker.

Mental Accounting

This is another concept under the behavioral finance field. This concept was founded by economist Richard Thaler. This theory contends that individuals divide current and future assets into separate and non-transferable portions or “accounts”. The separation of assets is based on subjective criteria and often has an irrational or negative effect on the individual’s consumption decisions and other behaviors.

Mental accounting is used a lot in everyday life and many people don't realize how illogical this thought process can be. How many of you have a special "money jar" or "piggy bank" set aside for a special reason, whether it be to buy a new car, home or even a vacation- while at the same time you are burdened with significant credit card debt?

Individuals who are in a situation such as the one above treat money in the "special" fund different to money that is used to pay off debt. However, this does not make sense since you are not earning any interest in that jar (or little in a savings account), while at the same time you are paying high interest on the credit card debt. Thus reducing your net worth!

The more rational thing to do would be to use the same money set aside in the jar to pay off that outstanding debt. So, why do we do this? The answer lies in the personal value we attach to these assets. We feel a sense of comfort knowing that we have some money saved for a house or education and are unwilling to give it up even if it means added financial benefit.

Another feature of mental accounting is the fact that people also tend to treat money differently depending on its source. How many times have you taken your bonus or money given to you as a gift and went on a wild shopping spree? Don't feel bad! It's a natural thing that people tend to spend a lot more "free" or "found" money compared to a similar amount of money that is expected or earned. Nonetheless, this is not logical since money should be interchangeable regardless of its source and as such spending it will only lead to a drop in your overall wealth.

With respect to investing, the mental accounting bias applies when an investor creates mental compartments based on particular events. The difference between these compartments sometimes impacts the investor behavior more than the events themselves. For instance, an investor might be hesitant to sell an investment that once had large gains and now has a modest gain. He would have created a mental compartment for the gains that he once had and since this compartment would be seen as more profitable than the current compartment- he would wait for the return of the gainful period. This is not rational, because the investor is not looking at fundamentals or reasons for the gains- he is looking at each compartment in isolation!

So, the key point to remember here is that money is money, no matter its source. Also, look at the bigger picture and think about your overall wealth at the end of the day rather than looking at things in isolation of each other.

Gambler's Fallacy

Last but not least, there is the Gambler's Fallacy. This occurs when an individual believes that a particular random event is less likely to happen following certain other events or a series of events. This is not accurate as past events do not necessarily change the likelihood that certain events will occur in the future.

For example, let's say you toss a coin ten times and each time it lands on "tails". Using the gambler's fallacy, a person might predict that the next coin flip is more likely to land with the "heads" side up. However, this way of thinking is totally illogical since the probability of a coin facing heads/tails is always 50 per cent. Each toss is independent of the next and as such previous flips do not affect upcoming outcomes.

Investors fall prey to this fallacy when they think that they should sell a share because it has gone up in a series of subsequent trading sessions and as such they believe that it will not be likely to continue going up- ***Fallacy: "what goes up must come down"***. The converse can be said for

investors who hold onto stocks where the share price is falling in consecutive sessions- believing that it will go up in the next session.

To avoid this irrational behavior, investors should base their decisions on fundamentals of the company and use technical analysis to determine trends.

Suffice to say, while the theories under Behavioral Finance do not show you how to beat the market, they do explain how human psychology can cause market prices to deviate from fundamental values over a period of time. The key point for investors: Be conscious of your behavior, it could be the difference in becoming richer as opposed to poorer.

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