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INVESTMENT PERSPECTIVES

Behavioral Finance 101

Academic research over the past fifty years in the fields of economics and finance has largely focused on what is known as modern portfolio theory (MPT). In summary, MPT asserts that 1) the stock market is efficient and therefore stock prices at any given time reflect their intrinsic, underlying values, and 2) investors act in a “rational” manner. Over the past decade, however, a competing view, Behavioral Finance, challenges the assumptions of MPT and has gained wider acceptance among both academics and practitioners of investment management.

Contrary to conventional economic theory, Behavioral Finance suggests that investors frequently don't make decisions based upon their own best interest or in a “rational” manner. Their decisions can be influenced by a number of factors including past experience, perceptions of what others think (social pressure) and emotions such as fear and greed. Behavioral Finance uses principles of economics and psychology to help explain how and why investors make decisions. Studies in this area indicate that we often rely on mental shortcuts or “rules of thumb” that can distort investment decision-making. In addition, some investors can be susceptible to recurring biases that can lead to faulty conclusions. Hutchinson Capital Management is aware of these biases and works to minimize their effects in our decision making, as well as capitalize on opportunities created by these biases in the stock market. The following is a list of some common biases:

- **Overconfidence Bias**

People can be subject to overconfidence in a variety of everyday activities. For example, in assessing our own driving abilities not many of us would rate ourselves as average or below average drivers. From an investment standpoint, research indicates that many investors overestimate their own predictive and forecasting skills. One study concluded that overconfidence was a factor that is “hazardous to your wealth.”¹ Investors with an overconfidence bias can overestimate their ability to assess an investment idea, trade excessively based upon their perceived knowledge, underestimate downside risk, and not adequately diversify—all of which can contribute to poor investment results. An example of

overconfidence bias occurred in the late 1990s when many investors concentrated their portfolios in the technology and telecommunications sectors. Overconfidence led these investors to misjudge or outright ignore potential downside risk.

- Representative Bias

Investors exhibit this bias when they make judgments and draw conclusions based upon a limited amount of information and data. In other words, there is an assumption that a small sample size is “representative” of a larger group or population. At a recent investment conference we attended, John Nofsinger, author of The Psychology of Investing, cited the following example of this bias: a used car buyer notices that a car is very clean and draws the conclusion that it runs well also. The assessment is based on superficial characteristics and therefore may or may not be accurate. Most people would agree that appearances can sometimes be deceptive. Investors can fall into this trap by making investment decisions based upon the recent strong performance of a stock, mutual fund and/or money manager. They assume incorrectly that short-term performance is indicative of long-term investment success. Another example of representative bias is the tendency to assume that the stock of a “good company” will be a good investment. General Electric, for example, has always been considered a very well managed company and before his retirement in 2001 many people were praising Jack Welch as the greatest CEO ever. However, in 2000 GE’s stock commanded a very high valuation (a price-to-earnings ratio of 40 times). Investors who bought the stock at that time (GE traded at an all-time high of \$60 per share in 2000) had poor returns in subsequent years due to the unrealistically high expectations reflected in GE’s stock price (GE currently trades at \$26 per share).

- Familiarity Bias

The familiarity bias is the tendency to believe that things we know are “better”. From an investment perspective, this can lead people to have the false perception that “better” equates to an investment with lower risk and higher potential returns. An example of this bias is best described by the large percentage of stock employees hold in their own company in their retirement plans. In 2000, for example, 62% of Enron’s 401(k) assets were invested in Enron stock.² With the eventual downfall of Enron and the collapse of its stock, one logical outcome would have been for the investing public to recognize the benefits of diversification. Put another way, how much was learned from other people’s mistakes? Apparently, not a whole lot. According to current estimates, approximately 42% of assets in 401(k) plans are invested in the company stock for which an employee works. Also, the median number of stocks held in brokerage accounts is only four.³ It is difficult for people to believe that a situation like Enron can happen to them. An obvious consequence of the

familiarity bias is that it can result in a lack of adequate diversification and significant downside risk.

- Loss Aversion Bias

Loss aversion bias is based upon the general observation that people psychologically have a stronger impulse to avoid losses rather than to generate gains.⁴ Under this concept, investors tend to hold losing investments too long and to sell winning investments too soon. It is common for the original purchase price of an investment to be a mental reference point and it is often difficult for investors to recognize a loss (or admit a mistake) even though selling and reinvesting in other opportunities would be more appropriate. Many people have the perception that they have only lost money in an investment when and if it is sold below the original purchase price and until then “it’s only a paper loss.”

- Investor Overreaction

Standard finance theory assumes that markets are efficient, that stock prices reflect all available information and are fairly priced. However, much of the research in behavioral finance supports the view that financial markets are not perfectly efficient and that investors consistently overreact to specific events or circumstances. Contrarian strategies, such as those practiced by renowned value investor David Dreman, seek to take advantage of these overreactions based upon the premise that investors consistently overvalue the prospects of the “best” (favored) investments and undervalue the prospects of the “worst” (out-of-favor) investments.⁵ Studies by Dreman show that value stocks (stocks with low price-to-earnings, low price-to-book and low price-to-cash flow ratios) outperform the broad averages over the long term. Put another way, stocks that investors are overly pessimistic about due to an overreaction to negative news can eventually lead to solid returns as the misperception by the market reverses over time.

At Hutchinson Capital Management, we recognize that behavioral biases exist and we use them to our advantage. Following are a few brief examples:

- Overconfidence Bias – In the late 1990’s we sold our technology and telecommunications stocks when we realized that they were significantly overvalued. By taking this action, we avoided the major bear market that started in early 2000.
- Representative Bias – The stock of a good company does not necessarily mean that it is a good investment. We do not buy stocks that are priced too high based on the fundamental value of a company. Our research process focuses on downside risk while much of Wall Street simply focuses on upside potential.

- Loss Aversion Bias – It does not pay to hold on to a losing stock. For example, when we realized that our purchase of AIG was based on incomplete and potentially misleading information, we immediately sold it. We had purchased it at \$46.97 on February 29, 2008, and sold it at \$36.99 on May 22, 2008. At July 1, 2008, the stock was selling at \$26.73 per share.
- Investor Overreaction – Since Wall Street is very short-term oriented, there can be an overemphasis on recent news, particularly if it is negative. If a stock is significantly down in price this can mean that there was unwarranted selling resulting in an opportunity for an investor with a long-term investment horizon to buy the stock at a low price. One of the basic tenets of our research process is to identify and buy quality stocks that, in our opinion, are considerably undervalued. We try to find stocks that are out of favor but whose long-term prospects are strong. We expect that 2008 will be a foundation year as we find a growing number of stocks that meet these criteria.

Our conclusion is that Behavioral Finance identifies a number of factors that both the individual investor and many institutional investors fall prey to in their search for profits. What may appear to be appropriate reasons for purchasing a stock are simply an investor's preconceived notions that are unrelated to successful stock selection.

Our research process strives to avoid these behavioral pitfalls by concentrating on a proven fundamental approach to investing. As we have explained in previous Investment Perspectives, we follow a disciplined approach to investing that has proven its worth over the years. Through both bear markets and bull markets, we shall continue to invest based on our fundamental research process.

¹ Michael M. Pompian, *Behavioral Finance and Wealth Management* (John Wiley & Sons, Inc., Hoboken, New Jersey, 2006): p. 51.

² Pompian: p. 165.

³ John Nofsinger, PhD, AFG Conference presentation notes, June 12, 2008.

⁴ Pompian: p. 208.

⁵ David N. Dreman. 2000. "Investor Overreaction and Contrarian Strategies." *Association for Investment Management and Research Conference Proceedings: Practical Issues in Equity Analysis*, no. 1: p.55.