EFFICIENT GROUP

ECONOMIC COMMENTARY

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BEHAVIOURAL FINANCE AND WHY IT MATTERS

The world of finance and investments is often associated with numbers and statistics but the real-world experience looks a bit different with behavioural patterns often playing a significant role in financial markets. Behavioural finance is the study of the psychological influences and biases that both investors and financial practitioners experience when making financial decisions. These influences and biases can explain some of the market anomalies that we observe, such as dramatic moves in stock prices that are unexplained by the numbers and available information alone. Behavioural finance, therefore, attempts to explain why investors make different decisions than would be expected from a perfectly-rational individual that only makes decisions based on facts and sound reasoning. When working with real-world investors, one quickly realises that constructing financial plans based on the 'optimal solution' that a perfectly-rational investor would prefer, often leads to suboptimal outcomes as investors struggle to stick to these plans because of their inherent biases. We, as financial practitioners, therefore, have an obligation to educate investors on the various pitfalls that behavioural biases create and, where necessary, adjust our recommendations to accommodate these biases.

One example where a middle ground may be found is when an investor exhibits a bias known as 'mental accounting'. This bias refers to the tendency of individuals to treat money, which should be seen as perfectly fungible, differently, based on the source or specific purpose assigned thereto. For example, individuals expecting to draw an income from their investment would often take on too little risk in their total portfolio because they tend to choose a 'safer' investment to the detriment of long-term performance. To accommodate investors, we often employ the bucket or layered approach to portfolio management, where each financial goal, whether it be income or growth, has its own sub-portfolio. The total portfolio is often less optimal than the perfectly-rational portfolio but the client is more likely to remain invested, leading to a better overall outcome.

Another common behavioural trait exhibited by both investors and financial practitioners is 'herding'. It is very common for individuals to 'follow the herd' when making decisions, which often leads to irrational behaviour and asset bubbles. History is full of examples of this phenomenon and, admittingly, it is very difficult to swim against the current, especially if you must do so over an extended period. We, as financial practitioners, must build controls into our processes to avoid making the costly mistake of comfortably following the herd to avoid being different. Advertisers have gained enormous reach through online marketing in recent years, which increases the risk of investors succumbing to this bias because they have the perception that 'everyone' is investing in this new product, increasing the feeling of FOMO (fear of missing out).

The list of behavioural biases that impact investors is extensive. We believe that the perfectly-rational solution, although theoretically optimal, might not be the correct recommendation for all clients in reality. It is, therefore, important to properly understand and identify biases that investors exhibit, educate clients and, if necessary, manage behavioural biases for the ultimate benefit of investors.