ARE INVESTORS RATIONAL?

Global Financial Private Capital

SYNOPSIS

- Behavioral economics combines psychology, economics, and finance to offer an explanation for why investors make irrational financial decisions.
- The Godfather of behavioral economics is Richard Thaler, and he won the Nobel Prize in economics this week.
- Investors can benefit from behavioral economics by learning to avoid psychological traps and recognizing when others are caught in them.

PREDICTING THE UNPREDICTABLE

Behavioral economics combines psychology, economics, and finance to offer an explanation for why investors make irrational financial decisions. Emotions are powerful forces that often override logical and reasoning, and this struggle can lead to suboptimal results.

There are countless examples, but a recent one worth discussing is the reaction of the U.S. stock market to the announcement that the citizens of the U.K. voted to leave the European Union back in June 2016. The media coined this historic event "Brexit," and the chart below shows the performance of the S&P 500 index over that time period.

The sharp V-shape dip that spanned less than a week (blue-shaded region) highlights two very different reactions to Brexit. The first was the initial fear and panic over the potential impact to the U.S., and the second was the quick recovery fueled by those investors who viewed the sell off as an opportunity.

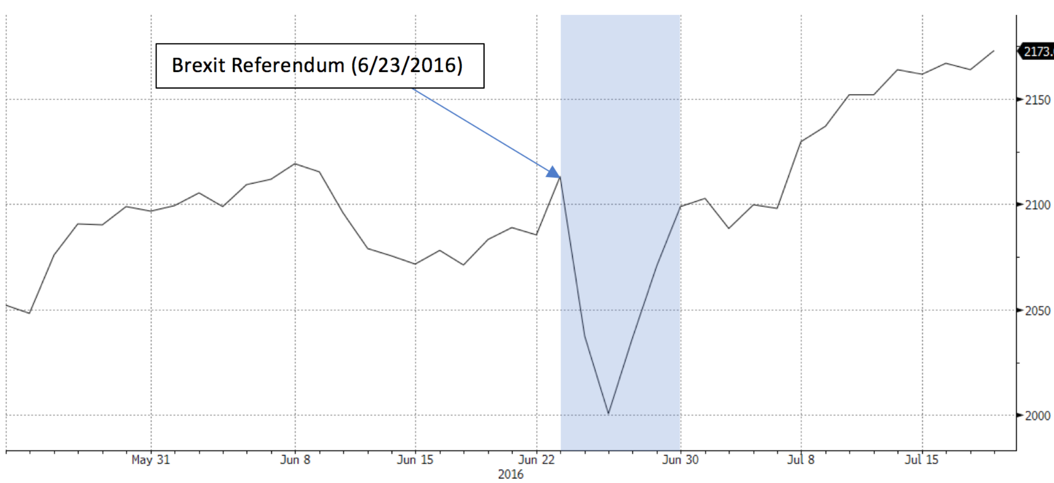
"Emotions are powerful forces that often override logical conclusions"

If someone were to only use traditional economic theory to explain this chart, they would likely be at a loss because nearly all conclusions are predicated upon the assumption that investors are rational and base their decisions on logic and reasoning.

In this instance, a "rational" investor should not have sold and based that decision on readily available facts such as these:

- **Legality**: The referendum was not even legally binding. It was advisory, not mandatory, so the U.K. government was under no legal obligation to do anything in response to the vote.
- **U.S. Impact:** The U.K. accounts for just 4% of U.S. exports, which is equivalent to about 0.5% of U.S. gross domestic product (GDP).

S&P 500 Index (May 24, 2016 – July 23, 2016)



Source: Bloomberg

- **Forecasting**: The U.K.'s 10-year government bond yielded less than 1% at the time, which is low for a country that faced imminent disaster.

Brexit is evidence of what gets preached in traditional economic and finance classes is not always observed in the real world. Behavioral economics attempts to bridge the gap by illustrating how outcomes get impacted by human behavior.

It also attempts to identify and explain why so many psychological biases lead to poor investment decisions. Examples include:

- **Confirmation Bias**: Looking for data that only confirm a belief and ignoring the data that contradict or even disprove this belief. Human nature tends to put more weight on what we believe versus what we do not.
- **Loss Aversion Bias**: Strongly prefers avoiding losses as opposed to achieving gains. This behavior is the primary reason why so many investors hold their losers even if the prospects for the investment to recover are low.
- **Self-Control Bias**: Failing to act in the best interest of long-term goals from lack of self-discipline. This bias can drive an investor to take on too much risk for the satisfaction of short-term returns vs. lower risk to achieving the long-term goal of financial freedom.

Equally important to avoiding these traps is recognizing when others are ensnared in them. In the example above, those who believed the selloff was irrational were able to profit from the fear and panic of others.

The beauty of their strategy was its simplicity. They did not need to predict the referendum results or spend months developing some proprietary investment thesis. All they had to do was to patiently wait for the irrationality of other investors to release blood into the water.

Simply put, behavioral economics can teach investors to not just control their own emotions but also recognize when others cannot.

IMPLICATIONS FOR INVESTORS

The Matrix was released back in 1999 and grossed close to half a billion dollars at the box office. The story is about a protagonist, named Neo, who feels that the world around him is not real. His relentless search for the truth eventually leads him to a man named Morpheus, who claims to hold the key to what he so desires.

Upon meeting for the first time, Morpheus offers Neo a choice. Swallow the blue pill and the story ends. Neo would wake up in his bed and he can continue to go on believing what others want him to believe.

The other option is the red pill, which will take Neo down the "rabbit hole" and bring him to the truth. Without hesitation, Neo swallows the red pill, and minutes later wakes up to the realization that his gut feeling was right. The real world was quite different than the dream he had been living in for so many years.

Fast forward to 2006, and as I sat in what seemed to be an endless number of economics and finance classes while working to obtain my M.B.A., I often felt a little like Neo, trapped in a world where the conclusions in my overpriced textbooks felt incomplete.

How could modern financial and economic theory still assume that decisions made by people are based on rational thinking? My classmates and I had just endured the dot-com bubble and was currently knee-deep in a housing market that was approving mortgages to people with nothing more than a basic credit check. To us, rational thinking had left town long ago.

Furthermore, how could simplistic mathematical models be used to predict something as complex and unstructured as human reaction to such events? Is this really how professional investors put their clients' money to work?

Then one day, a professor by the name of Richard Thaler walked into our classroom to teach behavioral finance. Mr. Thaler is well-regarded as the godfather of behavioral finance and has dedicated his career to the subject.

He explained why events like Brexit impact markets and presented data that flew in the face of traditional economics. He was our Morpheus, handing out red pills to those who yearned for the truth, and his teachings changed the way I view investing.

More specifically, three lessons have remained with me to this day. The first is to constantly challenge my own investment decisions to avoid psychological traps, and the second is to recognize when others have fallen into them.

The third lesson was gaining an appreciation for why successful investing is so difficult. On the surface, it seems logical and process-driven. Input data into a model and the output should be indisputable. However, the reality is that investing is often more an art than a science because the only predictable attribute to human behavior is that it tends to be unpredictable.

This week, Mr. Thaler won the Nobel Prize in economics for his multi-decade quest to upend many of the preconceived notions about how investors really behave versus what the textbooks preach. I cannot think of an individual more deserving of this award.

Mr. Thaler has written several books throughout his career, but for those interested, a great place to start is Misbehaving: The Making of Behavioral Economics, which was published back in 2015.

If you go down this road, be honest with yourself and have an open mind. Admit when you have succumbed to the pitfalls he discusses and view your past mistakes as learning exercises. Only then will you be able to scrutinize future decisions from an objective viewpoint.

The bottom line is that human behavior is a critical component to achieving one's financial goals, and it is important for investors to recognize psychological pitfalls to both prevent unnecessary risk and benefit from the mistakes of others.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer,
Global Financial Private Capital

Index Definitions
All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses. Past performance does not guarantee of results. Index returns do not reflect fees or expenses and it is not possible to invest directly in an index.
The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

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