Wharton @ Work
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FINANCE

INVESTMENT ADVICE: WHEN RATIONAL THEORIES MEET IRRATIONAL PEOPLE

Since 1952, Modern Portfolio Theory (MPT) has guided investors, and those who advise them, on how to reduce risk through diversification. After seventy years, the theory is still relevant, influencing standard practice and including newer asset **classes** such as hedge funds and private equity. The problem with MPT, however, says Wharton Associate Professor of Finance Jeff Jaffe, is when real people use it.

"The theory is based on rational behavior," Jaffe notes. But he tells a group of financial professionals in ***Investment Strategies and Portfolio Management*** to expect something different. "People don't behave that way. Even when they know that they should see greater returns by following certain **investment strategies**, they often don't follow them. The good news is that there are patterns to their irrationality. Behavioral Finance studies the patterns, and helps us understand what they are and what's behind them."

Jaffe, a leading authority on asset allocation who serves as academic director of the program, explains some of the more common biases:

LESSON IN REAL TIME

Issue:
You see room for improvement in your, or your clients', investment decisions.

Solution:
Understand common irrational investor behaviors to better recognize when emotions, not knowledge, are guiding your decisions.

1. **"Overconfidence** is in our genes, inducing us to take too much risk and trade too much. Interestingly, levels of overconfidence vary by gender and marital status. In many areas of life, including investing, single men are the most overconfident. They're followed by married men, then married women, and finally single women. A well-known study shows that the highest returns go to single women, and not inconsequentially, they're the people who trade the least."

2. **"Consideration of past performance** can negatively affect risk-taking. People who have done well are often willing to take on greater risk. This bias is known as the **House Money Effect.** It's a gambling term that describes behavior after an early win. The money placed on subsequent bets isn't considered your own, so you're less cautious with it.

   "On the flip side, those who have experienced a loss often become what academics call **Snake Bitten**. They tend to reduce risk. In the days and weeks following the market crash of October 1987, many people got out of the market completely. Of course, when it went back up, they were left out.

   "Other investors who experience losses exhibit '**Get-evenitis,'** increasing risk to make up for losses. And professionals aren't immune. For example, a study finds that **money managers** who do worse than their benchmark by the middle of year tend to increase risk taking during the last months of the year to 'get even.' It appears that Barings Bank derivatives trader Nicholas Leeson, who experienced significant losses in 1994, tried to get even. To cover those losses, he took extreme, unauthorized risks, eventually losing $1.4 billion and causing the collapse of the bank in 1995."

3. "People tend to like what they know, and **Familiarity**, or home bias, often means they don't diversify enough. Many investors don't buy foreign stocks for this reason, and employees tend to overinvest in their employers' stocks. For example, when Enron went bankrupt, employees lost their jobs and their **retirement** savings. Over 60 percent of their 401K assets were in company stock. But warnings from the highly-publicized event went unheeded. Just a few years later, 90 percent of Procter & Gamble 401K assets were in company stock, and that number was over 50 percent for the financial advisors at Merrill Lynch. The lesson, it would seem, isn't resonating."

4. **"Naïve Diversification** is the equivalent of eating at a buffet. You're not sure what to choose, so you take one of everything. It's not a good way to eat or to invest. If a retirement plan offers more stock funds than bond funds, research shows that investors put more of

their money in equities."

5. **"Regret and Pride** are also important biases. Wanting to feel good about the results of their decisions, some investors sell holdings after they have appreciated. They also hold onto losers because selling them would cause feelings of regret. This strategy is likely counterproductive for tax purposes, with investors harvesting tax gains rather than losses."

Once you're aware of these biases, is there anything you can do about them? Jaffe warns that investment advisors can only counsel their clients — they can't reform them. "If your client doesn't want to diversify, or if she wants to sell winners, you can explain the theory, but the choice is theirs. Being able to recognize these biases in yourself and in others is the first step in adjusting behavior. When you know you're being irrational, you can stop and reassess. You might not follow the highly rational theory perfectly, but you can make better decisions."