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The Fragreport

A Quick Intro to Behavioral Finance

March 2020 | Robert R. Fragnito | Chief Operating Officer | Financial Advisor

An underlying characteristic of financial markets is that they are driven by the actions of human beings. Even in the age of algorithmic trading and computerized models, human behavior remains a constant with investing.

Market participants were reminded of how impactful human psychology can be on financial markets over the past couple of weeks. For this reason, it leaves us asking: what really influences people to do what they do when it comes to investing in markets?

Behavioral finance or BeFi is a topic of tremendous interest in the financial industry, so much so that it has created an entire field of study devoted to answering this question. As we continue to face volatility in the market, we wanted to shed some light on a few basic concepts of behavioral finance.

Myopic Loss Aversion (MLA)

Let's face it, who hates winning and who loves losing? The answer to both questions is no-one! *Myopic loss aversion* is the overreaction by investors to get out of their investments during times of short-term substantial declines. This leads an investor to take on significant short-term loses at the expense of long-term gains. A simple long-term chart of the S&P 500 demonstrates that even significant dips in the market eventually lead to gains over time. A way to mitigate MLA is by thinking of your investments as a long-term endeavor, not a short-term one.

Confirmation Bias

Have you ever sat in your own echo-chamber? We all do, we all think we're right and *confirmation bias* is something we all play into. We inherently look to like-minded resources to confirm what we're thinking. We can withdraw from this self-created trap by seeking different opinions and asking ourselves tough questions. What could challenge this belief or conviction I have about this investment? Am I really being objective? This is no easy task, but rational thinking can really help alleviate making potential mistakes in the market.

Hindsight Bias

I knew this was going to happen! We cannot predict the future. We can make very good educated guesses, but the reality is that there are many events in time that are not predictable. *Hindsight bias* for investors is often confirmed by a past success in markets and perpetuates into a self-driven narrative of attempting to predict future outcomes. I want to note, financial advisors make this mistake too. All investors have made money and all investors have lost money. We can look to the past for answers, but it can only take us so far. Let's keep in mind, history doesn't repeat itself, but it often rhymes.

Herd Mentality

"But everybody's doing it Mom!" Your mother replies: "Would you jump off a cliff if everybody was doing it?" Then reality sets in, but you probably spent a second thinking about what you were going to do in that scenario. *Herd mentality* is a popular BeFi concept and has been used to explained drops and bubbles in financial markets. It highlights the irrationality of investors in moving the market in a direction based on fear, uncertainty, or influence of the crowd. This behavioral bias really strikes at the core of our humanity and is truly emotionally driven. Investing without a plan really makes an investor susceptible to this risk, and the best way to decrease it is by creating a plan and sticking to it.

Final Thoughts

As we can see from this brief introduction into behavioral finance, we have probably fallen into one of these biases at one point or another. We cannot deny that psychologically is fueling the volatility we are seeing in financial markets at this time. The resort to panic, in our view, is being driven by the fear of the unknown impact of the coronavirus on the global and domestic economy. Unfortunately, we won't really know the impact for a few months, but this cannot detract investors from seeing the bigger picture of what investing is all about. Investing is about the long-haul not a short sprint.

We at MCF are very aware of what role psychology plays in markets and how it can affect an investor's portfolio. What enables us to deal with situations like this is our disciplined approach through quantitative market data analysis. As I mentioned earlier, the best defense for events like this is having a plan, without it—we become victims of circumstance and fall into the trap of emotional investing. Our approach allows us to rise above the bias and be confident for the long run.

As we reflect on these recent events and continue to navigate the headwinds of market volatility, we can look to the past to draw inspiration and move forward, for *the only thing we have to fear is fear itself* (Franklin Delano Roosevelt).

MCF Insight:

- Coronavirus Market Impacts and Future Outlook
- Five Things to Remember with Your 401(k) in Volatile Markets

Behavioral Finance Resources:

- behavioraleconomics.com
- BehavioralFinance.com

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