Behavioral finance: A panel discussion

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1. Behavioral finance: A panel discussion

Filbeck: Welcome to the panel discussion on behavioral finance. The purpose of this panel discussion is to provide an overview of financial behavior of major stakeholders, financial services, investment products, and financial markets as it examines financial and emotional well-being and processing beliefs, emotions, and behaviors related to money. The basis for the content being shared by our panelists comes from the book Financial Behavior: Players, Services, Products, and Markets edited by H. Kent Baker, Greg Filbeck (me), and Victor Ricciardi and published by Oxford University Press in 2017. The book is a part of the Baker–Filbeck Financial Markets and Investments 11-book series by Oxford University Press. Kent and I published a similarly structured panel discussion based on topics covered by two other books in the same series on risk management (Baker, Filbeck, Holzauer et al., 2015) and private equity (Baker, Filbeck, Ahmed et al., 2015). While each book in the series offers a historical grounding of theoretical and empirical subject matter including a mix of contributions between academics and practitioners, each title also focuses on the latest trends. We believe these panel discussions focused on the marriage of theory and practice are essential in presenting the majors themes of present study based on what we know today as well as identifying ideas for future research studies based on current trends.

Vic and I would like to thank our fellow panelists for their contributions to our Financial Behavior book as well as their willingness to share their knowledge with us today. Bloomfield (2010, p.23), states that traditional finance

…sees financial settings populated not by the error-prone and emotional Homo sapiens, but by the awesome Homo economicus. The latter makes perfectly rational decisions, applies unlimited processing power to any available information, and holds preferences well-described by standard utility theory.

Behavioral finance is a field of finance that proposes psychology-based theories to explain stock market anomalies such as severe rises or falls in stock price.

Ricciardi: Much has been published on behavioral finance. Let’s briefly introduce some of the interesting biases and sample research studies, first based on overconfidence. Overconfident investors refer to the fact that as human beings we have a tendency
to overestimate our own skills and predictions for success. Barber and Odean (2001) examine the trading behavior based on the notion of gender bias for a sample of 35,000 client accounts over a six year investment horizon. The findings suggest that males are more overconfident than females in terms of their investing abilities and males trade more frequently. Males tend to sell their stocks at the wrong time and also reveal higher trading costs than females. Females tend to trade less, utilizing a buy and hold strategy resulting in lower trading costs. Males traded 45 percent more than females while single males trade 67 percent more frequently than single females. Trading costs decreased the net investment returns of men by 2.6 percent per year and only 1.7 percent for women. An extensive amount of research literature in behavioral finance reveals people have a tendency to be overconfident regarding their financial and investment decisions. This overconfident behavior is linked to over trading and too much active investing resulting in lower investment performance.

Next, let’s turn to studies on status quo bias. Status quo investors refer to the group of investors that has an inclination to suffer from inertia, procrastination or inattention toward their financial judgments and decisions. The study by Mitchell et al. (2006) examines the trading behavior of employees invested in 401(k) plans. The study utilizes a sample of 1.2 million workers enrolled in 1,500 different retirement plans, with most of the 401(k) plan investors categorized by intense inactivity. The study reveals that most employees in defined contribution retirement plans suffer from status quo bias in which only a small percentage savers execute any trades, and a very small number trade actively. Nearly all retirement investors (approximately 80 percent) execute no trades, and an additional 11 percent makes just a single financial transaction over a two-year period (2003–2004). Investors suffer from inertia and are related to the failure of the pure “buy and hold” strategy. To overcome this bias, retirement savers should rebalance their accounts at least once per year.

Next, let’s turn to studies concerning worry and risk perception. The study by MacGregor et al. (1999) focuses on how the financial decision-making process is linked to various aspects of investments/asset classes, specifically expert’s perceptions of returns, risk, and risk/return associations. A survey was mailed to financial advisors in which the 265 participants that responded were asked to provide their assessment of a series of 19 asset classes with 14 specific variables. The main findings revealed with the utilization of multiple regression analysis with perceived risk as the dependent variable that three significant factors (worry, volatility, and knowledge) explained 98 percent r-square of the experts’ risk perception. Finucane and Melissa (2002, p. 238), further comments, “perceived risk was judged as greater to the extent that the advisor would worry about the investments that the investments had greater variance in market value over time, and how knowledgeable the advisor was about the investment option”.

Finally, based on a study on framing and risk, we can attempt to answer the question of what type of negative emotions and issues did investors experience two years after the financial crisis in 2008? Based on an online survey of 1,697 investors, most investors hold both stocks and bonds in their investment portfolios (Ricciodi, 2011). When posed the question: Which do you worry about more, stocks or bonds, 20 percent indicated that they did not own both stocks and bonds, but 70 percent indicated stocks worry them more, while 10 percent indicates bonds were more worrisome. This survey was taken February 2010 to June 2010 by Nightly Business Report viewers and Kiplinger’s Personal Finance readers as part of the “Your Mind & Your Money” series. FinaMetrica administered the survey and the collection of data. This framing issue demonstrates how financial experts can communicate differently with their clients about the meaning of risk. In this example, the phrase worry can be substituted for the technical and objective definition of risk especially when discussing this topic with novice clients.

Filbeck: Now it’s time to hear from our panelists. The first question: What are some of the primary examples of cognitive, emotional, and social biases?

Spieler: Some examples of cognitive biases include (1) Illusion of control: people tend to believe that they can control or influence outcomes when, in fact they cannot and (2) Conservatism bias: people maintain their prior views or forecasts by inadequately incorporating new information. Some examples of emotional biases include (1) Loss aversion bias: asymmetric utility with respect to equal size losses and gains. Investors tend to prefer avoiding losses as opposed to achieving gains and (2) Overconfidence bias: people demonstrate unwarranted faith in their own intuitive reasoning. Examples of social biases include (1) Herding effect: Investors trade in the same direction or in the same securities, and possibly even trade contrary to the information they have available to them. Herding effects individuals, analysts and portfolio managers and (2) Social trends and paradigm shifts have brought behavioral biases to the forefront including changing attitudes to taking risk (e.g., the desensitization to lotteries and gambling). In addition, the decline of pension funds has forced individuals to take on the responsibility of investing via 401(k)s. Technology and internet trading has made investing (too) accessible and easy for uneducated investors.

Fan: A quick Google search reveals that there are 101 cognitive biases, 27 social biases, and 49 memory biases reported by Wikipedia. Among them, 27 biases are regularly mentioned in behavioral finance. Primary examples of widely-recognized behavioral biases in finance include overconfidence, loss aversion, disposition effect, and anchoring effect.

Evensky: Here are the comments I often hear that symbolizes overconfidence: “I can time the market”. “I can pick better managers than most”, and “The talking heads on TV know something others do not”. They demonstrate representativeness with thoughts like “Morningstar gave a fund a 5 Star rating, so it must be good”. Availability bias is exhibited with statements like “I like to buy IPOs”. They make the headlines, but across the board they make lousy investments. (Case vs Base data). Salience bias holds logic similar to not taking your umbrella out today because it didn’t rain yesterday and is a good way to get soaked. So is buying the hot fund of the last 10 min.

Holzhauer: The first bias that comes to my mind is the availability heuristic, which allows a person to make mental shortcuts based on what information is quickly available from their memory, experiences, and imagination. However, given proper reflection, probably the most researched cognitive bias in behavioral finance is overconfidence. Overconfidence bias is created when people believe their personal qualities are better than they really are. A prime example of this is with driving cars. One can quickly pull any room and find that most people believe they are a better driver than the average driver. However, statistically some drivers are simply average and others are below average. In financial research, overconfidence is looked at from a variety of corporate, investment, and even regulatory angles. For example, Hirshleifer (2008) and Hirshleifer and Toeh (2009) both explore overconfidence in policy analysts and explain how overconfidence by policy analysts can lead to adopting too many regulations. Overconfidence is also plays a role in several biases that prevent investors and managers from accurately calculating probabilities such as gambler’s fallacy, hot hand fallacy, illusion of control, and winner’s curse. Some other well-known cognitive biases include representativeness, anchoring and adjusting, framing, and risk aversion.
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