BEHAVIORAL FINANCE

A Discussion with Nicholas C. Barberis, PhD

Interviewed by Anthony B. Davidow, CIMA®

Nicholas C. Barberis is the Stephen and Camille Schramm Professor of Finance at the Yale School of Management. Professor Barberis’ research focuses on behavioral finance—in particular, on applications of cognitive psychology to understanding investor trading behavior and the pricing of financial assets. He has published extensively in the top economics and finance journals, given frequent presentations about his work to both academic and nonacademic audiences, and has won numerous awards for both research and teaching. He earned a PhD in business economics from Harvard University and a BA in mathematics from Cambridge University.

Professor Barberis spoke at IMCA’s 2015 Summer Institute powered by Yale University. Following the presentation, Tony Davidow sat down with him to talk about behavioral finance.

Davidow: Terrific job today. Clearly, behavioral finance is something that is very relevant to the audience. Advisors deal with aspects of it every day, and one of the biggest challenges is how do they overcome the irrational behaviors of their clients.

Let’s start our discussion by talking about the two big frameworks in finance, the “rational agent” framework versus the “behavioral finance” framework, and why the latter has really taken off in recent years. You provided examples of why you believe that behavioral finance took a while to gain a broad following.

Barberis: A lot of people date the start of systematic financial research to the 1950s, and from the 1950s to the 1990s or so financial research was dominated by the rational agent framework that assumed that market participants are fully rational. It is actually a useful and important framework, but by the 1990s, it became clear that it is just not sufficient for understanding many important things in the world. That really propelled the rise of behavioral finance, which argues that a lot of what happens in financial markets may be the result of less than fully rational thinking on the part of some people.

It wasn’t clear 20 years ago how successful or widely applicable behavioral finance would become. I think now, 20 years later, we see a whole range of important applications. For anyone who wants a full understanding of financial markets, I think it is essential to know something about behavioral finance.

Davidow: You talked about three of the most prominent ideas in behavioral finance: over-extrapolation, overconfidence, and prospect theory. Let’s start with over-extrapolation. Please provide a high-level overview of what it is, and what some of the implications are for advisors.

Barberis: Over-extrapolation is the idea that when people form beliefs about the future, they base those beliefs too much on the recent past. For example, if an asset, asset class, or fund has had high returns in the recent past, people are too quick to think that the asset, asset class, or fund is going to have good returns in the future as well. You can find direct evidence of such over-extrapolation in surveys where we ask people to forecast how the stock market is going to do in the future.

Over-extrapolation has been a very useful concept for addressing fundamental questions in finance. For example, why the stock market and real estate market have fluctuated so much over the decades; why bubbles seem to form at regular intervals; and why we see momentum and reversals in security returns.

All of these striking facts in finance can be understood in a simple framework where a lot of people just think that what will happen in the future is what has happened in the recent past. If you have a lot of investors in the economy who think that way, you are naturally going to get excessive fluctuations in markets. You are going to get bubbles. And you are going to get momentum and reversals. Over-extrapolation seems to be a simple and plausible way of understanding a lot of basic facts.

Davidow: You also discussed overconfidence. I think most advisors can relate to the fact that clients remember their successful investment ideas but often forget their ideas that didn’t work out so well. Talk a little bit about overconfidence, and the implications for advisors. Specifically, you discussed the implications of over-placement and over-precision. Can you enlighten our readers about these two behaviors?
Barberis: Overconfidence is a slightly overused term. Let’s at least break it down into two related concepts. One is overplacement, which refers to the fact that most people believe themselves to be above average on various dimensions, for example, driving ability or sense of humor or attractiveness; but of course we can’t all be above average, so many people are deluding themselves. Another type of overconfidence is overprecision, the fact that people tend to be too confident of the accuracy of their forecasts.

Overconfidence can help us make sense of a number of striking facts—for example, the very high volume of trading in financial markets, or the high volume of acquisition activity among firms despite the fact that many acquisitions turn out poorly. The idea here, articulated decades ago by Warren Buffett among others, is that many chief executive officers are overconfident and underestimate how hard it is to make a merger work. This idea now has rigorous empirical support.

Davidow: Prospect theory has gotten a lot of attention because of Daniel Kahneman’s work. We were fortunate to have Daniel Kahneman speak at our 2015 IMCA New York Conference. He discussed the great lengths that clients will go to avoid losses—a behavior that may be related to prospect theory. You specifically discussed loss aversion and probability weighting. Could you describe these two types of behaviors, and maybe what some of the implications are for advisors?

Barberis: Probability weighting is an aspect of prospect theory that is not so well known. But I think that is going to change because it seems to be useful for thinking about many facts in financial markets. It is the idea that the brain processes probabilities in a nonlinear way and, in particular, tends to overweight low-probability outcomes. That can be seen in the way humans like to buy both lottery tickets and insurance policies.

Probability weighting has been used to understand, for example, why the stock market has had so much higher an average return than Treasury bills over the past two centuries. We know that the stock market is subject to occasional large crashes. So, if your brain overweights that low chance of a large crash, you are going to find the stock market scary and are going to demand a high average return as compensation.

At the same time, probability weighting also explains why initial public offering (IPO) stocks earn surprisingly low average returns in the long term. IPO stocks are a bit like lottery tickets. They offer a small chance of an extraordinary return if you happen to buy the next Google or Microsoft. If our brains overweight that low probability of a spectacular outcome, we are going to be too attracted to assets like IPOs. We are going to overpay for them, and that might explain why, on average, they have low returns in the long term.

Davidow: One of the things that you shared today was the fact that individual investors are strongly impacted by their personal experience in the market. You talked about clients who got into the market in the 2000s, didn’t have a good investing experience, and then invested very differently from those who were exposed to the market in earlier decades. For those clients who were in the markets longer, they could recall more positive outcomes where they made money, while the newer investors experienced losses and more volatility.

It is an interesting and relatable phenomenon. Can you talk about this concept? How can advisors either overcome this perception, or re-orient clients so they focus on the longer-term results?

Barberis: Yes, I think it is a very interesting idea that is getting a lot of traction. We’re actually finding many different applications of it. It appears to play a role in the corporate finance context as well where, for example, we see executives who have lived through a time of economic crisis tending to be more conservative in their use of debt.

I know that researchers are actively trying to find ways to help people overcome this, to look at data other than the data they have personally experienced. I think it will be challenging because there is evidence from neuroscience that the brain separately stores facts that you learned about in books and facts that you learned through your own experience in life. So, trying to get people to pay more attention to one kind of memory—or one kind of fact—than another is going to be challenging.

A first step is to alert people to this phenomenon and to point out to them that we have a tendency to overweight things we have personally experienced, and that we should also put some weight on things that may be relevant but that we haven’t personally experienced. I think just making this point can help shift people’s views.

Davidow: I think most advisors would admit that clients don’t always make rational decisions. I think many of our advisors are aware of behavioral finance and the implications for dealing with their clients. It’s a topic that has been covered at our conferences and through our publications. However, the fact of the matter is that there is a difference between understanding it and being able to do something about it. How do you take the research and change the discussion? You gave an example of something as simple as changing the terminology that we use with clients. You discussed how individual investors like to sell things that have done well—so they can be a winner—and avoid selling things that have done poorly. Even though it is an irrational behavior, we know that clients behave this way. How do we potentially change this and get them to do the right thing at the right time?

Barberis: One thing that is fascinating about being a financial advisor—other than the importance of the task—is that in a way you are called upon to be a psychologist as well. I think an important part of the job is trying to understand why your clients are drawn to suboptimal behaviors. What is the psychology behind this? And then, what is a creative way of trying to counter it? How can you explain things, or how can you frame things for clients to try and introduce a new psychology? I think...
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Barberis: We have to recognize that there is still so much that we don’t know. Even commonplace statements such as “emotions cause investment mistakes” are still poorly understood from a scientific perspective. But if 25 years of behavioral finance research have taught us anything, it’s that an understanding of psychology can be helpful for interpreting the financial decisions that people make. So I encourage financial advisors to pick up a book on psychology—Kahneman’s Thinking, Fast and Slow is a great place to start—and to think about how the ideas in that book might be used to understand and help their clients.

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Davidow: Professor Barberis, this interview has been very enlightening for me. As we discussed, our advisors are working diligently on behalf of their clients. They are putting their clients’ interests first, and trying to get them to focus on their long-term goals and objectives. Yet, as you’ve pointed out today, our clients will often make irrational decisions that hurt them over the long run. Are there any words of wisdom that you’d like to share with our advisors? How can they better identify these behavioral biases, and anticipate some of the related challenges?

One possibility that I’ve heard of is that even the language you use can make a difference. Instead of asking a client to close out their position at a loss, perhaps we can talk about how they should “transfer” the proceeds to a different investment. Just by using the word “transfer,” you are trying to help the client avoid thinking of this as closing the position at a loss, and instead to think of it as an ongoing transaction where we are just going to move the funds somewhere else.

That is a fascinating subject that is a large part of a financial advisor’s job.

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