Behavioural Finance: An Introduction to Human Error

“The first principle is that you must not fool yourself, and you are the easiest person to fool.”

–Richard Feynman, Recipient of the 1965 Nobel Prize in Physics, speaking in 1964

Paul Samuelson’s 1941 Ph.D. dissertation on economics, grandly titled The Foundation of Economic Analysis, changed the standard for analysis of economics by incorporating mathematical analysis in economic theory. But, in order for Samuelson’s math to work, he had to make assumptions and generalisations about the way in which people behaved, both in isolation and when part of a social group. Keys among those assumptions were that people nearly always behaved rationally and in their self-interest while incorporating perfect information (humans were so-called homo economicus). Today, we know that those assumptions do not hold true in the investing world.

More Than Just Maths

Benjamin Graham may have been the first behavioural investor on record when he eloquently wrote in 1949 of the humanlike Mr. Market in his book The Intelligent Investor. In that work, Mr. Market was a manic depressive business partner who offered to sell his shares to his partners cheaply when he was depressed and buy them expensively when he was exuberant. Graham’s suggestion for Mr. Market’s business partners was to take advantage of Mr. Market’s irrational behaviour by buying low and selling high.

But it took a few decades for academic research to catch up to Benjamin Graham. In 1974, a decade after Richard Feynman spoke the words quoted above, psychologists Daniel Kahneman and Amos Tversky published Judgment Under Uncertainty: Heuristics and Biases, a seminal work in behavioural economics and finance. Kahneman and Tversky were trying to understand why so many of our prescriptions were wrong—why homo economicus often miscalculated, made bad choices, and why markets often “misbehaved.” Theirs was a positive or experimental analysis as opposed to the normative analysis used by Samuelson and others.

Kahneman and Tversky were smart academics who found many ideas for their social science experiments in the mistakes they themselves made as well as the mistakes their intelligent colleagues and subjects made. They understood that intellect was not necessarily the cause of the anomalies. Arnold Wood, Editor of Behavioral Finance and Investment Management published by the Research Foundation of the CFA Institute, declared that the tipping point for the discipline of behavioural finance was October 10, 2002, which was the day that Daniel Kahneman won the Nobel Prize in Economics and legitimised the field.

Biases, Behaviour and Money

For investment managers like SEI what matters most are the identity of biases, and the ways to combat those biases in ourselves and make intelligent decisions when we see others acting on biases. In a series of future papers on the topic of behavioural finance, we will discuss the most common biases, how they affect behaviour and how SEI attempts to avoid behavioural-based investment mistakes and exploit those behaviours in other investors.
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