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BEHAVIORAL FINANCE IN PORTFOLIO MANAGEMENT

BY HALEY J. SCHUBERT, CFA, CFP®, MANAGING DIRECTOR, CLEARSTEAD

"Meme stocks," "WallStreetBets," and "To the moon!" are all modern-day examples of behavioral finance in action. Back in 2020 when the world was on lockdown, excitement around "meme stocks" was born. Internet memes were shared on Reddit's r/wallstreetbets and retail investors piled into equity positions in names like GameStop and AMC. The trades were purely speculative in nature and the stocks were trading well above their estimated value. Investors did not perform fundamental analysis and were not behaving "rationally" as defined by Modern Portfolio Theory. Investors exhibited some of the most common behavioral biases including overconfidence, herding, and eventually loss aversion, holding onto losing positions. For example, AMC stock peaked at $450.10[1] in the summer of 2021 and ended 2023 trading at just $6.12[1] a share. It is important to understand the emotional influences at play when making investment decisions to maximize successful outcomes.

WHAT IS BEHAVIORAL FINANCE?

Behavioral Finance is the study of the psychological influences at play when making investment decisions. Economists study investor biases and situational influences that lead to "irrational" behavior.

Let's first look at the early forms of behavioral finance. Early models describing investor behavior were created by Barnewall in 1987 and Ballard, Biehl, and Kaiser

CLEARSTEAD ADVISORS ANNOUNCES ACQUISITION OF WILBANKS SMITH AND THOMAS

Clearstead has acquired the assets of Wilbanks Smith and Thomas Asset Management, LLC ("WST"), a Norfolk, Virginia based wealth and investment management firm with over $5 billion of assets under management. The combination continues Clearstead's rapid growth trajectory and further consolidates Clearstead's position among the leading RIAs in the US. After the merger, Clearstead Advisors and its subsidiaries will have approximately $44 billion in total assets under advisement, including $20 billion in total assets under management, 225 employees, and offices in nine cities.

In addition, the six WST partners will become shareholders in Clearstead, increasing the total to 65 employee-owners of the firm. The advisory business of WST will be rebranded as Clearstead Advisory Solutions, a Division of Clearstead Advisors, LLC and continue serving clients from offices in Norfolk and Roanoke, Virginia, and Raleigh, North Carolina.

Read the full Press Release here: https://www.clearstead.com/in-the-news/clearstead-announces-acquisition-of-wilbanks-smith-and-thomas/

in 1986. The Barnewall model was created to help financial advisors understand client behavior. It segments investors into two categories—passive and active. Passive investors established their wealth passively, either by inheritance or risking the capital of others. Barnewall concludes that passive investors have a lower tolerance for risk. On the other hand, the active category of investors made their wealth by risking their own capital. The result is an individual with a higher risk tolerance, but one that prefers to maintain control over their investments. Ballard, Biehl, and Kaiser also aim to categorize investors, but their model places investors along two axes; level of confidence and method of action. They created five classifications for investors including The Adventurer, The Celebrity, The Individualist, The Guardian, and The Straight Arrow. For example, "The Guardian" is careful and anxious. Retirees are often assigned to the "Guardian" category and are concerned about having sufficient assets to last their lifetime.

BEHAVIORAL FINANCE CHALLENGES MODERN PORTFOLIO THEORY

A baseline for "rational" investor behavior is commonly described by Modern Portfolio Theory (MPT), which was pioneered by Harry Markowitz back in the 1950s. MPT assumes that all investors are risk-averse; investors will always select the portfolio with the lowest level of risk for a given level of expected return. The theory assumes that investors are rational, and decisions are made only after logical analysis; emotional reactions do not occur. In addition, the theory assumes that all investors have access to the same information and form the exact same views with said information. Conversely, behavioral finance concludes that investors are "normal" rather than rational. Individuals are often influenced by their own biases resulting in cognitive errors.

BIASES IN PORTFOLIO MANAGEMENT

Common biases found by analyzing investor behavior include inertia, naïve diversification, overconfidence, loss aversion, anchoring, confirmation bias, and mental accounting.

Inertia is the tendency to stick with an initial decision and fail to make any changes over time. Inertia is commonly seen when analyzing investment decisions in individual's 401k retirement plans. A common practice in portfolio management is to reduce an individual's allocation to risky assets as they near retirement, but studies found that many individuals do not alter their 401k investment selections overtime and instead implement a "set it an forget it" strategy.

Naïve diversification can also be seen by analyzing the decisions of Defined Contribution plan participants. Studies by Benartzi and Thaler found that many plan participants use a "1/n" diversification strategy. Investors divide 401k contributions equally among available investment options and do not consider the underlying investments in the fund strategies. The result is a portfolio that is not appropriately diversified by asset class, style, market cap, etc.

Overconfidence bias leads individuals to overestimate their financial knowledge and underestimate risk. It is commonly seen with employees investing in their company stock as they feel they have superior access to information and a sense of control. A recent example is the collapse of Silicon Valley Bank that saw extraordinary returns in 2020 and into the fall of 2021 before the entire market cap was erased in a matter of months. It is a reminder of the importance of considering contradictory information when making an investment and proper portfolio diversification.

Loss aversion is common with individual investors as people strongly prefer avoiding losses versus achieving gains. Individuals that hold onto "losers" with embedded losses are subject to the disposition effect, resulting in an inefficient allocation of capital in the market.

Anchoring is another cognitive bias with sharp contrasts to MPT. Individuals create an "anchor" based on initial information and do not properly adjust the anchor when given new information. The result is often incorrect forecasts and contradictory views by investors with access to the same information.

Confirmation bias describes an individual's tendency to search for information that confirms their initial beliefs. Individuals either ignore conflicting information or fail to analyze new information in a rigorous fashion. A common mistake is incorrectly accounting for probabilities of independent events.

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Mental accounting is seen when individuals have separate buckets of money based on intended use and timing of the funds. The result is often a less efficient use of assets and cash drag.

Revisiting the "meme stock" craze, you can understand how many of the behavioral biases are intertwined. For example, individuals investing in AMC Entertainment likely exhibited overconfidence bias, assuming they had superior access to information from Reddit's r/wallstreetbets and, therefore, superior knowledge and skill. In reality, most of the investors did not have the financial knowledge to perform fundamental analysis and did not properly assess the stock's risk and return characteristics. Confirmation bias was also at play as individuals searched only for information confirming they should hold the stock (or purchase more shares), rather than considering contradictory information that could lead to a sell decision. In addition, individuals likely created an "anchor" based on initial information and did not adjust the anchor appropriately when given new information (i.e., AMC earnings reports). As AMC stock began its descent in late 2021, many individuals exhibited loss aversion and inertia, holding onto losing positions to avoid locking in a capital loss.

BRIDGING THE GAP – HOW TO AVOID BEHAVIORAL FINANCE MISTAKES

Awareness is key. Understanding that cognitive biases exist can lead to better financial decisions and actions can be taken to minimize the emotional influence on the investment decision making process.

Focusing on "time in the market" rather than "timing the market" can limit emotional decisions stemming from fear. Many investors timing the market often sell at the wrong time due to fear or buy at the wrong time because of greed.

For high-net-worth individuals that are not comfortable with public market volatility, investing in illiquid markets can complement an overall investment strategy. Given that private markets are illiquid and control rests with the fund manager, many of the cognitive biases are inherently removed from the equation.

Lastly, working with an advisor to navigate the financial markets can lead to more successful investment outcomes. Trusted advisors can remove the emotional attachment to financial assets and construct portfolios based on quantitative and fundamental decision-making processes.

Source:

behavioral-finance-investment-processes.pdf (cfainstitute.org)
(1) Bloomberg.

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Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

March 31, 2024		1M	3M	12M	YTD
US Large Cap	S&P 500	3.2%	10.6%	29.9%	10.6%
US Small Cap	Russell 2000	3.6%	5.2%	19.7%	5.2%
Developed Intl	MSCI EAFE	3.3%	5.8%	15.3%	5.8%
Emerging Intl	MSCI Em Mkt	2.5%	2.4%	8.2%	2.4%
Real Estate	NAREIT	1.9%	-1.3%	8.4%	-1.3%
Core Fixed	BarCap Agg	0.9%	-0.8%	1.7%	-0.8%
Short Fixed	BarCap 1-3Yr	0.4%	0.4%	3.5%	0.4%
Long Fixed	BarCap LT G/C	1.6%	-2.4%	-1.1%	-2.4%
Corp Debt	BarCap Corp	1.2%	-0.4%	4.1%	-0.4%

Source: Bloomberg

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