Input on Behavioural Finance

Academic studies conclude that investors are far from uniformly 'homo economicus'.
Investment behaviour is influenced by compelling factors other than rationality.
The example below supports the view that much investment behaviour is emotional.

Topic: The Dangers of the Anchoring Effect

Contributed to Joseph Palmer & Sons Investment Committee Meeting

Key Points

- **The anchoring effect describes the behaviour of many investors when deciding a buy or sell price.**
- **The effect, if not carefully managed, distorts reasoning in otherwise reasonable investors.**
- **Research confirms universal susceptibility to anchoring and its deleterious impact on wealth.**

This article was researched, created and produced by Eddie Lees, an independent member of the Joseph Palmer & Sons Investment Committee.

The central theme of these articles is that many of the precepts of classical economics are rightly challenged by the relatively new science of behavioural finance.

This series of one-page synopses has been created by reference to numerous academic papers, whose authors include:

- BARBERIS, N. C.
- EPSTEIN, M.J.
- HUSSEIN, A.H.
- KAHNEMAN, D. & TAVERSKY, A.
- KADIYALA, P.
- LEE, T.A. & TWEEDIE, D.P.
- MONTIER, J.
- SHEFRIN, H.
- SHILLER, R.J.
- SUBRAHANYAM, A.
- THALER, R.C.

'Anchoring' can be most detrimental to the best interests of investors; it is, in fact, something we all have a tendency to do, and which we should almost always try to avoid. It is the tendency to evaluate buying and selling decisions around a specific number which emotionally latches itself into our minds based on dangerous misconceptions.

A personal example is instructive: Nancy L is the daughter of friends of mine. Around eight years ago, her parents urged her to invest in Sydney's property market; it had a hit a low mark and, in their opinion was bound to rise again shortly. Nancy took their advice, obtained a loan and purchased an apartment for $250K in, what was then, a backwater. A little later, other smart apartments sprang up and values in the area began to rise. Earlier this year, chit-chat among neighbours suggested that apartments like Nancy's would fetch north of $600K. She decided to sell and spoke to Tom, a real-estate agent. He warned her that prices had peaked but that $590,000 should be achievable.

Nancy agreed and, mid-year, her apartment was on the market. Prospective buyers came around, inspected and conferred with Tom on offers that might be acceptable. At the end of the first month, Tom relayed that the best offer, so far, was $580K. Nancy declined.
Tom had said that five hundred and ninety thousand dollars should be achievable – and *that* (the price to which she had anchored her expectations) was what she wanted.

The weeks dragged on; the press wrote ever gloomier articles about the property market; and offers for the apartment kept falling. Even though Nancy lowered her expectations, they were never very far below her 'anchor price'.

Three weeks ago, tired, anxious and frustrated, Nancy finally sold her apartment for $495,000, which was far lower than chit-chat had suggested, significantly lower than the price suggested by the agent, and precipitously lower than the first offer made.

The effect of anchoring to a price that had latched into her mind had cost Nancy dearly. Yes, she had made a substantial gain on her initial investment – but missed out on a reasonable offer, all because her behaviour was manipulated by a psychological trick.

The bias towards anchoring applies equally to decisions on buying and selling securities. When an investor buys a share for $XX, it's that price that anchors itself into the investor's mind.

No matter the logic, no matter the arithmetic, no matter the reasoning, many an investor will use that anchor price as a benchmark against which to base a price at which to sell.

And in most cases, that behaviour will cost the investor dearly.

The team at Joseph Palmer & Sons neither anchor valuations to buy or sell prices, nor do they fall in love with securities in the many portfolios they run.

The team employs sophisticated research and 'relative value analysis' to guide decisions – 'anchoring' is totally absent from their reasoning. As it should be.