A Case Study In Behavioral Finance

SYNOPSIS
- Behavioral Finance is a field of study that combines psychology, economics, and finance to provide an explanation for why investors make irrational financial decisions.
- Several market pundits continue to fear over a possible correction in the S&P 500 and are searching for any data to support their belief.
- A seemingly isolated incident at a bank in Portugal this week caused global markets to decline, which is yet another example of how the bears are desperate to find any reason to sell.

We Are All Human
Behavioral Finance is a field of study that combines psychology, economics, and finance to offer an explanation for why investors make irrational financial decisions. Our emotions are powerful forces that often override logical conclusions, and this struggle typically leads to suboptimal results.

Traditional finance theory assumes all investors to be rational, a highly unrealistic scenario, so it’s critical for an investor to have a basic understanding of the emotional traps that exist in markets. Not only will spotting these traps protect your portfolio over the long run, but you will also get better at recognizing when others have become ensnared, which are some of the best times to seek profit.

NOTE: All market participants are prone to emotional forces in their investment making decisions, which is why it’s so important to have an investment team consisting of diverse opinions and skillsets. Our Investment Committee is a great example of such a team because we operate as a “checks and balances” system for portfolio design, buy/sell decisions, and asset allocation.

Here are just a few examples of the biases, or traps, that investors must avoid in order to reduce risk:

- **Conservatism Bias**: Maintaining a prior forecast by inadequately incorporating new information. An example would be an investor that is so sure of his reason to buy a stock that he then completely disregards new information that contradicts or even disproves his thesis.
• **Confirmation Bias**: Looking for data that only confirm a belief and ignoring the data that contradict or even disprove this belief. Human nature tends to put more weight on what we believe versus what we do not.

• **Loss Aversion Bias**: When an investor strongly prefers avoiding losses as opposed to achieving gains. This behavior is the primary reason why so many investors will hold their losers even if an investment has little or no chance of going back up.

• **Self Control Bias**: When one fails to act in the best interest of long-term goals due to a lack of self discipline. For example, an individual who spends money now instead of saving for retirement. This bias will often cause an investor to take on too much risk for the satisfaction of short-term returns vs. lower risk to achieving the long-term goal of financial freedom.

These biases explain some of the greatest market euphoria (dot-com boom) and bubble bursts (financial crisis) in recorded history. They have existed for thousands of years and they will exist for thousands more to come.

**Can Portugal Really Cause a Correction?**

Worries over the financial health of a Portuguese bank spooked global markets on Thursday, sending global markets down including the S&P 500. The catalyst for the concern stemmed from a missed payment on short-term debt issued by the country's second largest lender, which then sparked fears over a possible contagion in the European financial sector.
The Investment Committee struggles to see how a single bank in Portugal can cause billions of dollars in equity value to simply disappear. To explain why, let's first look at the charts below which offer a visual representation of just how irrelevant Portugal is to the global economy:

**Annual GDP (BLN USD)**

- United States
- Japan
- France
- India
- Australia
- Indonesia
- Egypt
- Portugal

**Country Market Capitalization as Percent of World Market Capitalization**

- U.S.
- Japan
- United Kingdom
- Hong Kong
- Canada
- France
- Germany
- Spain
- Italy
- Portugal
Portugal accounts for 0.14% of the global market, which is roughly 1/10th the size of Italy. Furthermore, this chart represents the entire economy of Portugal so imagine the impact of one bank here is to the overall global economy (keep in mind that this bank did not fail or go out of business).

Furthermore, fears over contagion appear to be extremely low given that the rest of Europe is far more financially secure than Portugal, and the European Central Bank (ECB) has explicitly stated that they will not allow the Eurozone to fail.

Despite this evidence and the positive U.S. economic data released over the last two weeks, investors panicked and sold stocks here because many feared over the beginning of a broad correction in U.S. equities.

**NOTE:** A correction is defined as a 10% or greater decline in an equity index. Currently we have not experienced a correction in the S&P 500 since 2011, and many market pundits have spent the last six months predicting a correction solely because one has not happened in a longer than normal time period.

This panic selling in the S&P 500 is a classic example of confirmation bias. In the face of a rising economy, an unemployment rate not seen this low since before the financial crisis, and robust consumption from consumers and businesses alike, the bears simply scoured the headlines until they found data that could loosely support their theory.

**Implications for Investors**

Here’s where behavioral finance can be frustrating and profitable at the same time. Although the data show that Portugal is practically irrelevant, we still admit that it could ignite a correction. Timing these events is impossible and there’s been so much media time dedicated to the subject that we could very well talk ourselves into one as bears point to anything even remotely supportive of a selloff. This is the part that can be frustrating because corrections are not always rational.

However, the Investment Committee enjoys nothing more than to profit from the fear and panic of others, and we welcome any major market correction due to concerns over a single missed payment at a bank that continues to operate in a country that comprises 0.14% of the global economy. This is the part where behavioral finance can be profitable!
The bottom line is that we may not be able to predict emotionally driven corrections, but we do stand to profit when they occur because our team is highly skilled at recognizing when these biases are driving irrational behavior in markets.

Sincerely,
Mike Sorrentino, CFA
Chief Strategist, Aviance Capital Management

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