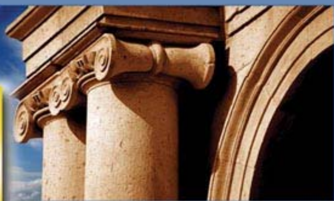

# Behavioral Finance

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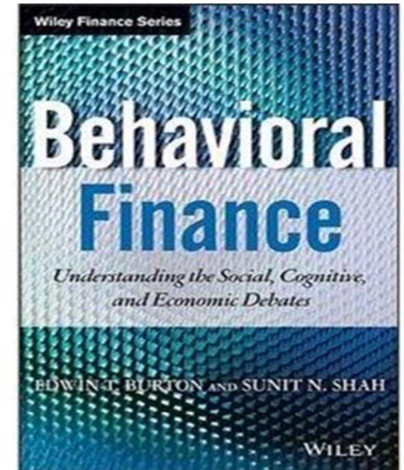
The story goes something like this: One day an oil man passes away and finds himself at the Pearly Gates. He is greeted by St. Peter who says, "Sir, you've lived an exemplary life but our quota for oil men full at the moment. You will have to spend some time in Purgatory." This didn't sit well with the oil man who responds: "St. Peter, if I can free up some room, will you let me in?" "Certainly," St. Peter replies. The oil man asks St. Peter if he can chat with his old friends for a few moments. He does and he casually drops the rumor that there have been some oil finds in Purgatory. There soon is a line of oil men asking St. Peter to let them out. St. Peter, somewhat puzzled, says to the oil man "There is certainly room for you now." To which the oil man replies, "Thanks, but I am going to follow the other guys. There might be some truth to that rumor."




What, you might ask yourself, does this have to do with investing?

It is an example of "herd mentality," the idea that people are influenced by their peers to take action; buy stocks, listen to certain music, wear certain clothes, etc. Call it peer pressure. It is a root cause of financial manias from the 1600s tulip bulb mania to the internet bubble of the late 1990s.

Herd mentality is one of the many ideas explored by Dr. Edwin Burton, a popular University of Virginia economics professor, in his book "Behavioral Finance." The general thesis of the book is that there is a lot more than market efficiency and rational decision making that goes on when people invest their money. Burton is a member of Chase Investment Counsel's board of directors and a frequent speaker at our annual conferences.

Traditional economic study is based on two fundamental assumptions: People act rationally in making decisions and make those that offer them the greatest happiness, or "utility," in economic terms. Secondly, markets are deemed to be "efficient," an idea that says that any asset's price (especially a stock's price) fully reflects all information available on the company and is thus an accurate reflection of a company's value. Beating the market, in such a world, becomes impossible.

To anyone actually involved in markets, the ideas of efficiency and rationality are nothing more than laughable notions by ivory tower academics. If markets are efficient, what led to the one-day drop of nearly 23% in the Dow Jones Industrial Average of October, 1987 and its subsequent recovery by year-end, or how can you have companies' with little revenue, no earnings, etc. get to multi-billion dollar valuations at the peak of the internet bubble in 1999, only to collapse a year later

The answers may lie in the interplay between human psychology and investment decision making.

There is, as noted, "herd mentality." There are several other situations Professor Burton discusses in his book. They include "risk aversion"- the idea that losses of some dollar amount make us feel worse than gains of the same dollar amount make us feel better; "anchoring," – placing a value on an asset that has little to do with reality and maintaining that value in light of new information and "saliency," the notion that we might put too much weight on recent events in predicting future outcomes and not enough weight on older events that conflict with the recent ones.

Professor Burton discusses topics that apparently contradict. For example, the concept of momentum seems to fly in the face of another concept – reversion to the mean. In stock markets, momentum generally refers to the price action of a stock, or the market as a whole, and suggests that stocks with the strongest momentum tend to keep that momentum and outperform the market for a period in the future. The idea that momentum works has been documented in several studies cited by Professor Burton. The Wall Street adage "the trend is your friend" is basically an acknowledgement that momentum exists and is worth heeding.

Reversion to the mean suggests the opposite. The stocks that have underperformed dramatically in the past will tend to "catch up" to the market, suggesting a period of outperformance. Again, this trend has been documented by several academics. Reversion to the mean is a key element in any "contrarian" investment strategy. "Buying straw hats in the winter" is but one Wall Street adage reflecting this investment strategy.

People often ask us whether we incorporate any elements of behavioral finance into our work at Chase Investment Counsel. The answer is an unequivocal "yes." We've done so for virtually the 55 years since the company's founding by Derwood S. Chase. To which the question becomes how could we have been using one of the newest areas in investment research for more than half a century.

We've long been big believers in and users of technical analysis as one of our tools in making investment decisions. Technical analysis has a lot to do with behavioral finance. In a nutshell it is the study of the price and volume action of a stock or a market with the belief the study can help in future investment decision making.

Momentum is an important part of our decision making process. We use several measures to gauge short and medium term price momentum of stocks and are believers that stocks with positive momentum now tend to keep it for some time period in the future. And we watch stocks losing momentum closely – it is one of our stronger sell signals. We are also big believers in earnings momentum – stocks that surprise "the Street" with higher-than-expected earnings in one quarter are likely to do so again in the future and provide good investment opportunities.

Seasonal factors affecting the market as a whole to some extent have had an impact on our investment process as well. Professor Burton discusses the legendary "January factor," notion that stocks, especially smaller ones, tend to do extremely well early in the year. Another seasonal affect we think about is the "Sell in May and go away" pattern, again a long-known trend for markets to post their biggest gains between November and May and their smallest gains, or biggest losses, between May and October.

To us, behavioral finance, technical analysis and fundamental analysis are simply tools. Markets, as Professor Burton accurately says, are tough things to beat. It has long been our thought that having more tools available to help us is a good thing.

Regards,

Peter W. Tuz, CFA
President