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Human Behaviour and Investing

June 2011

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Behavioural Finance

• In the five years from October, 2002 to its peak in October 2007 the Australian share market generated a total return of 178% (as measured by the S&P ASX 200 Accumulation Index). Since that time the Index has fallen by 20.5%.

• 121%

• **Loss Aversion** – Research from the field of 'behavioural finance' suggests that investors feel the pain of a loss much more deeply than the pleasure of an equal gain. This behaviour – known as loss aversion – can have a significant effect on how investors act.

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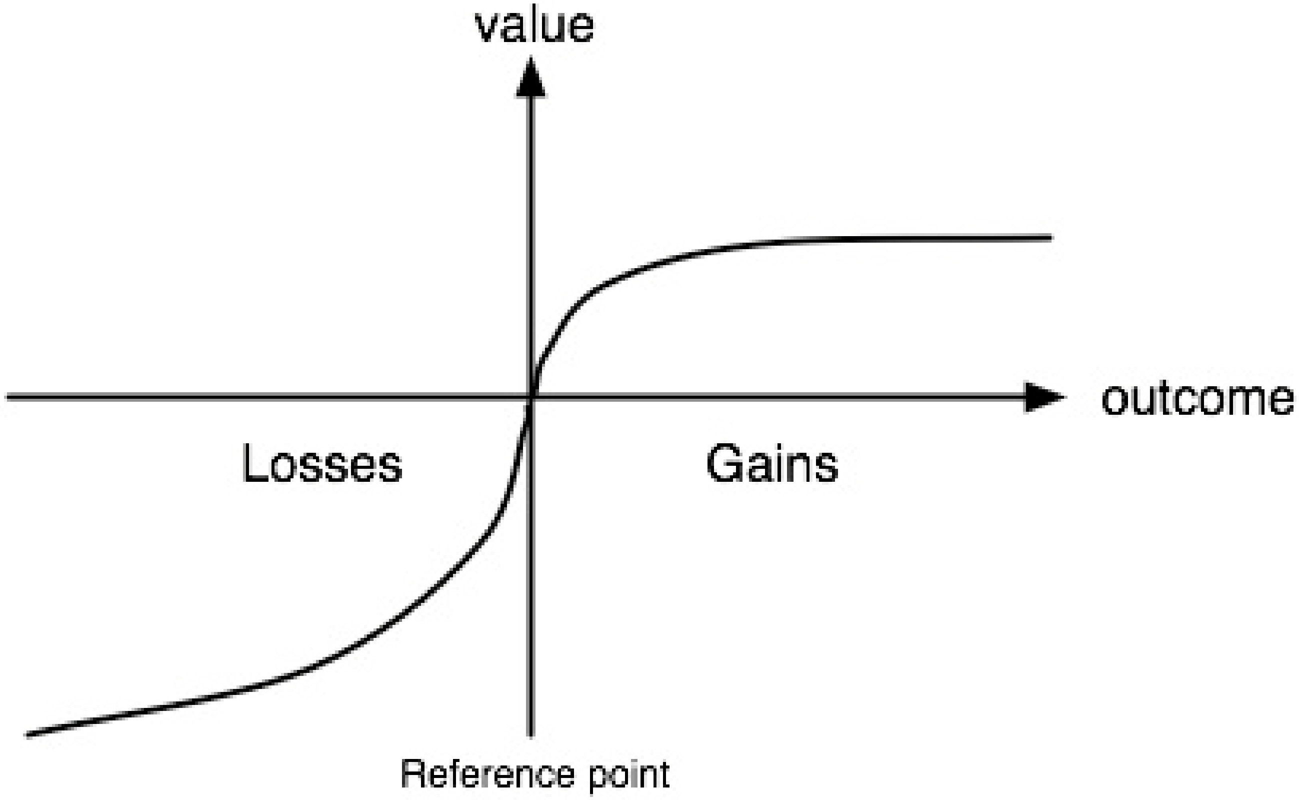
- The value function is defined on deviations from a reference point and is normally concave for gains (implying risk aversion), commonly convex for losses (risk seeking) and is generally steeper for losses than for gains (loss aversion)



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How Loss Aversion affects decisions

- SBS aired a documentary “Foolproof Equations for a Perfect Life” illustrated Loss Aversion example

Presented different passerby's with a situation involving money and risk with a slight twist:

1. Gave one group £20 and offered the chance to gamble it in a game of Roulette to win £50
2. Gave the other group £50; took back £30 and offered them chance to “win it back” in a game of roulette

- Expected outcome of scenarios is exactly the same, however the reaction of the groups were starkly different

- Loss Aversion induced a disproportionate number of participants to behave irrationally and gamble in second situation vs. first situation people happy to walk away with £20

Money Illusion

- Refers to our tendency to think of currency in nominal, rather than real (purchasing power) terms.

- Disputed by some economists who contend that people act rationally.

- Look at the way people talk about their own house prices.

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Important notice