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Human Behaviour and Investing

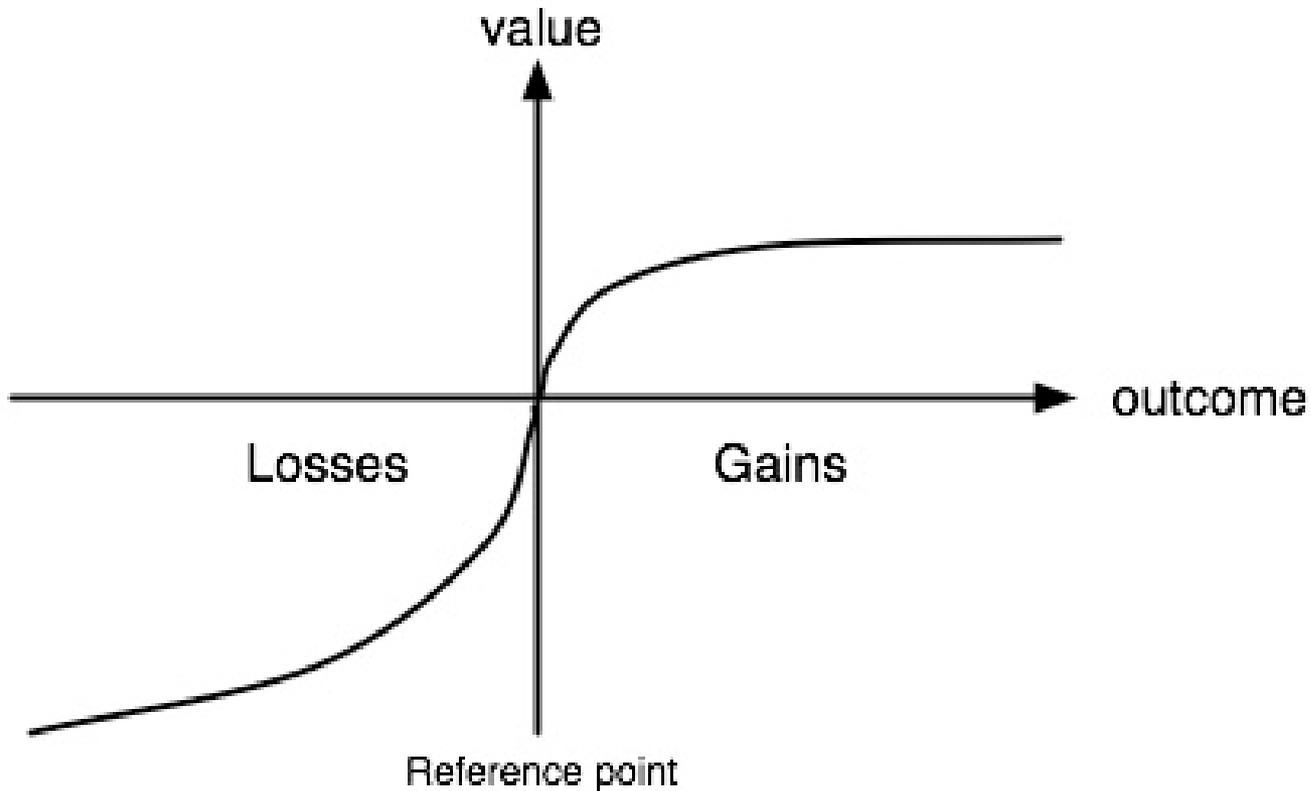
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Behavioural Finance

- 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)



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
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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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