

“Behavioural Finance & Investment”



SIAS Jubilee Lecture

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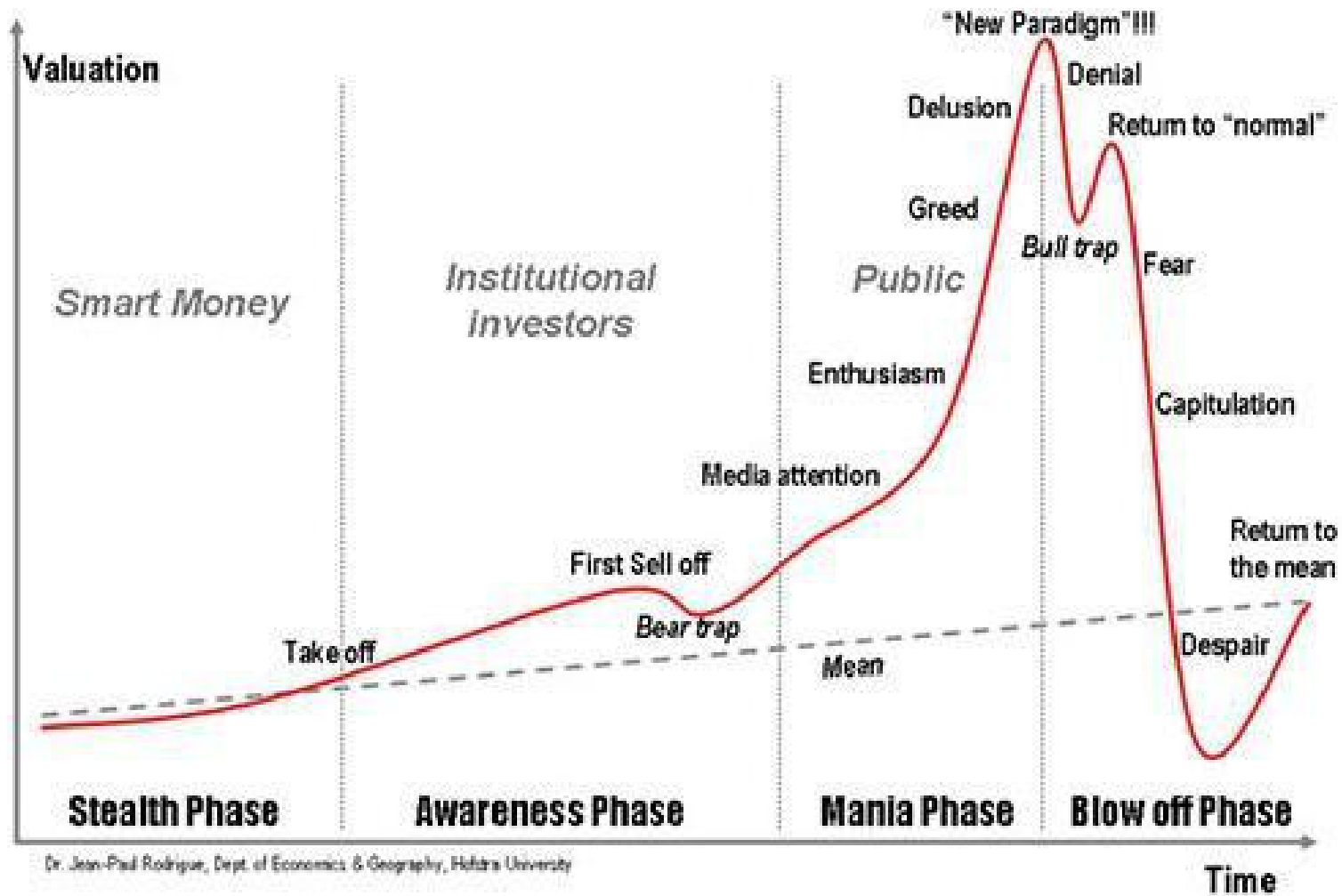


Isaac Newton's nightmare

Isaac Newton's Nightmare
South Sea Stock
December 1718 – December 1721



Anatomy of a bubble



Dow Jones 1900-1950

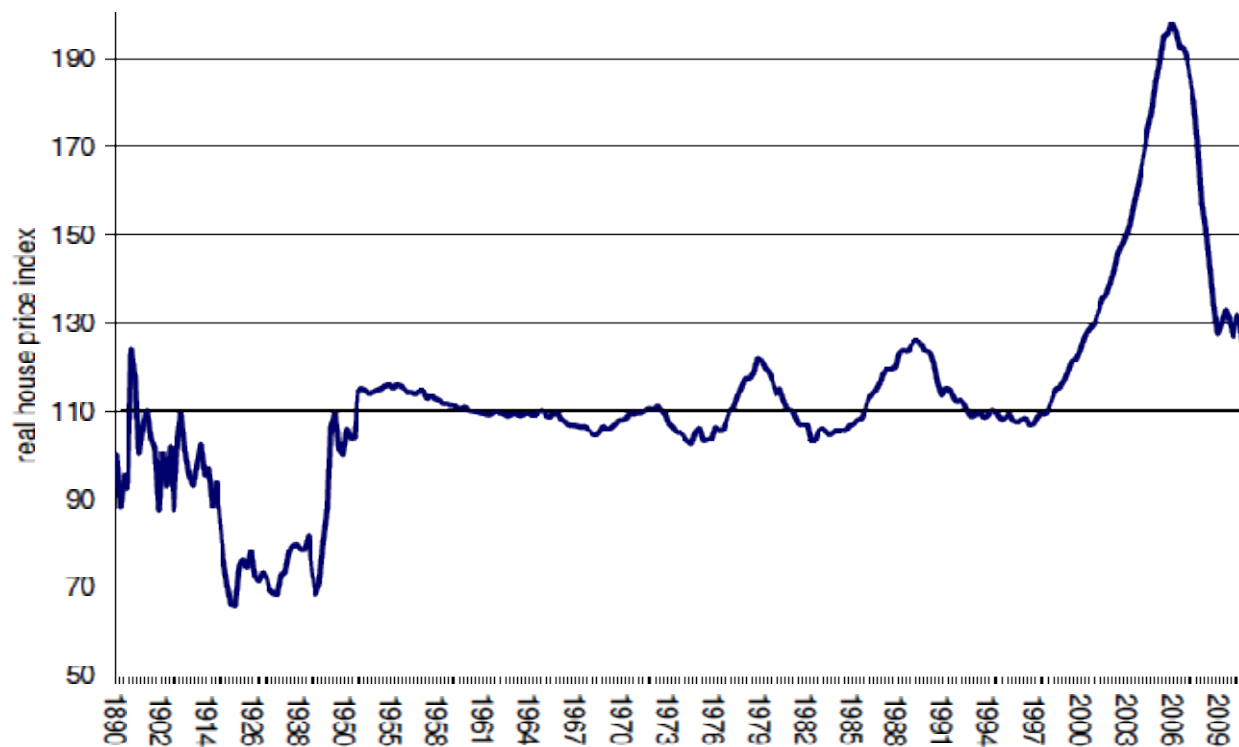


Nikkei 1965 - 2012



US house prices 1890 - 2010

Fig 5: US House price series (real, Shiller data): 1890 - 2010

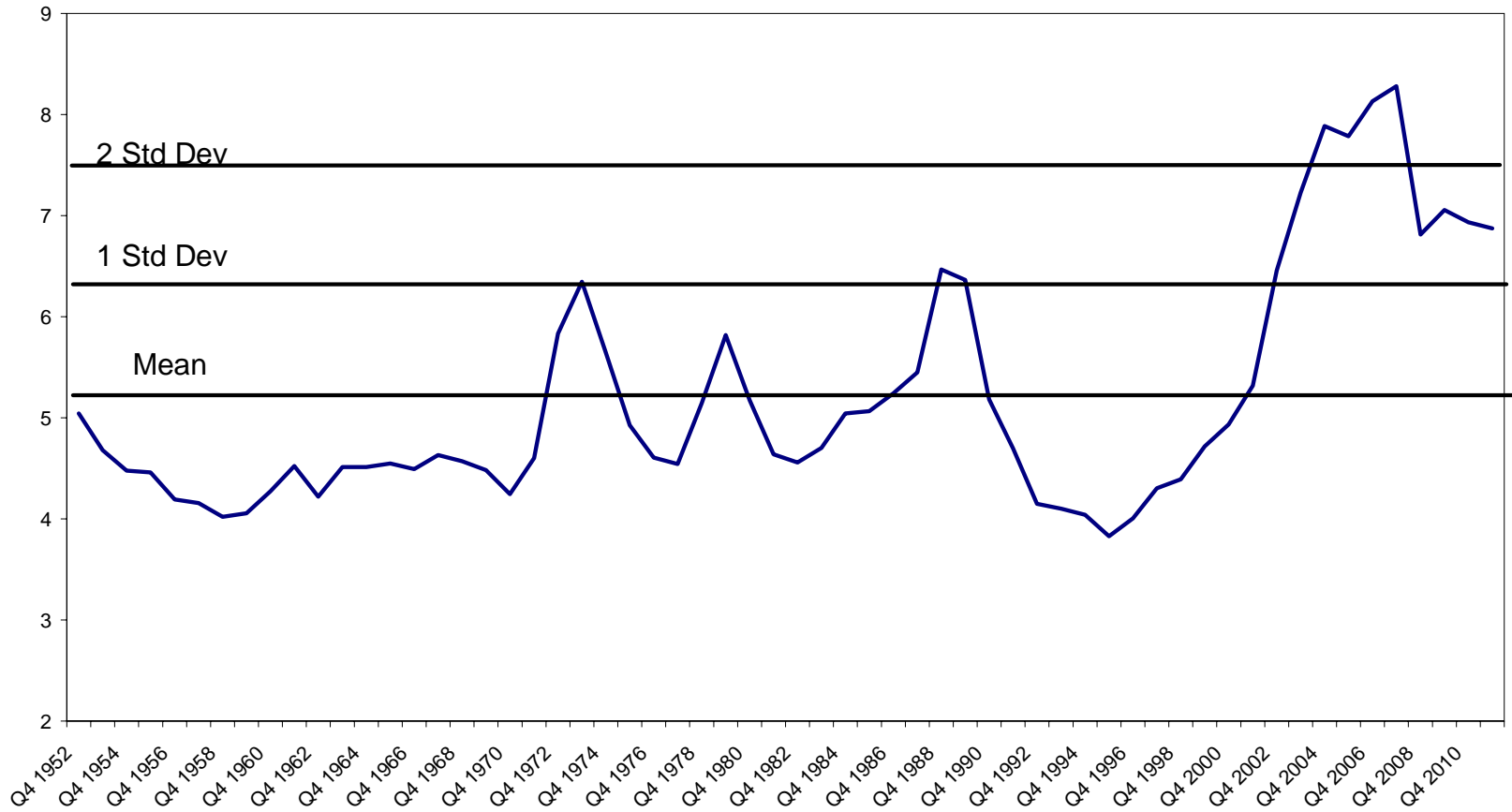


The US is the most advanced of all the Western examples, in terms of deflating its housing bubble. Indeed, on this data, US real house prices are close to being back to their long term trend line (i.e. back close to 110)

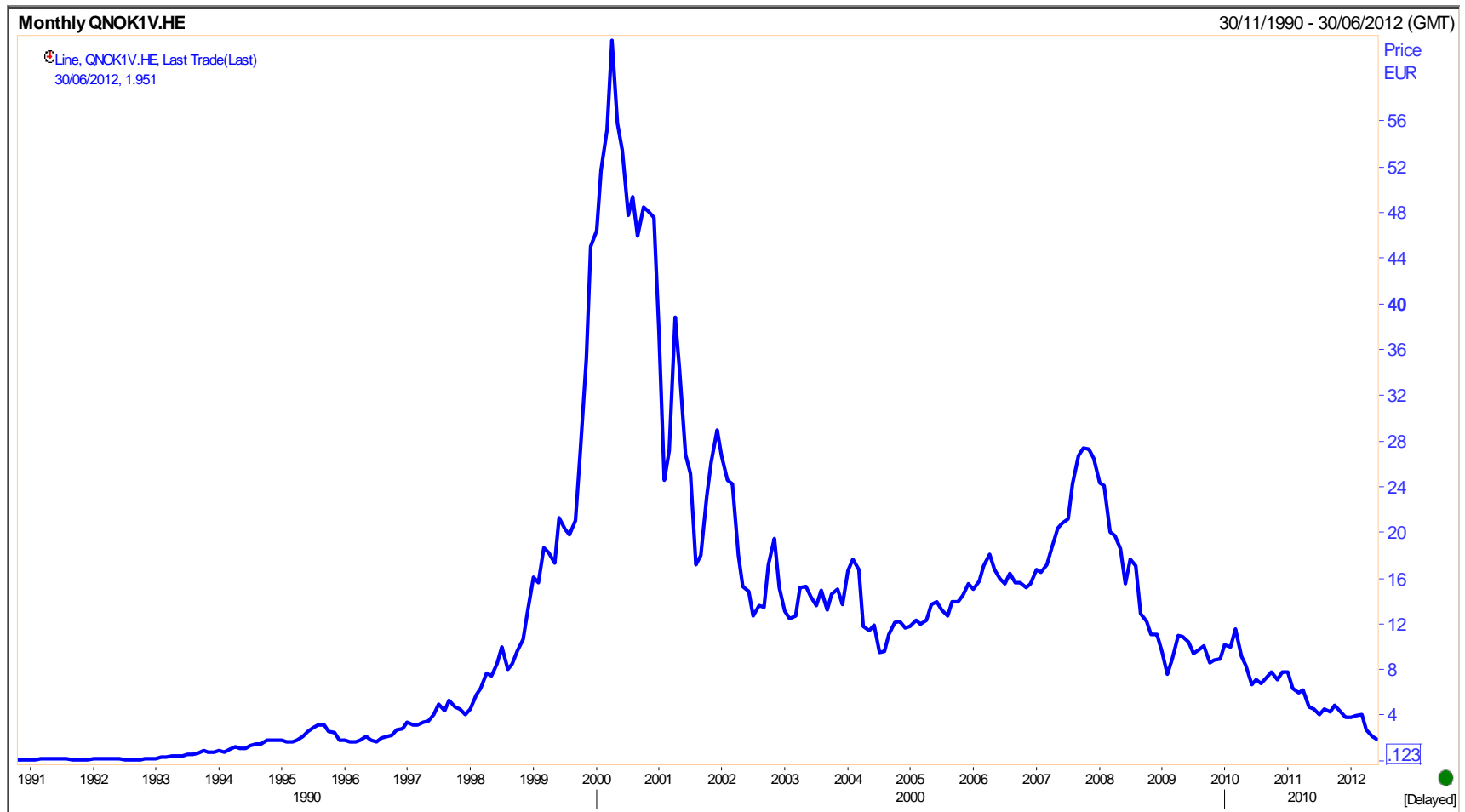
Source: Longview Economics 16 4 2012

UK House Prices to Average Earnings 1952-2012

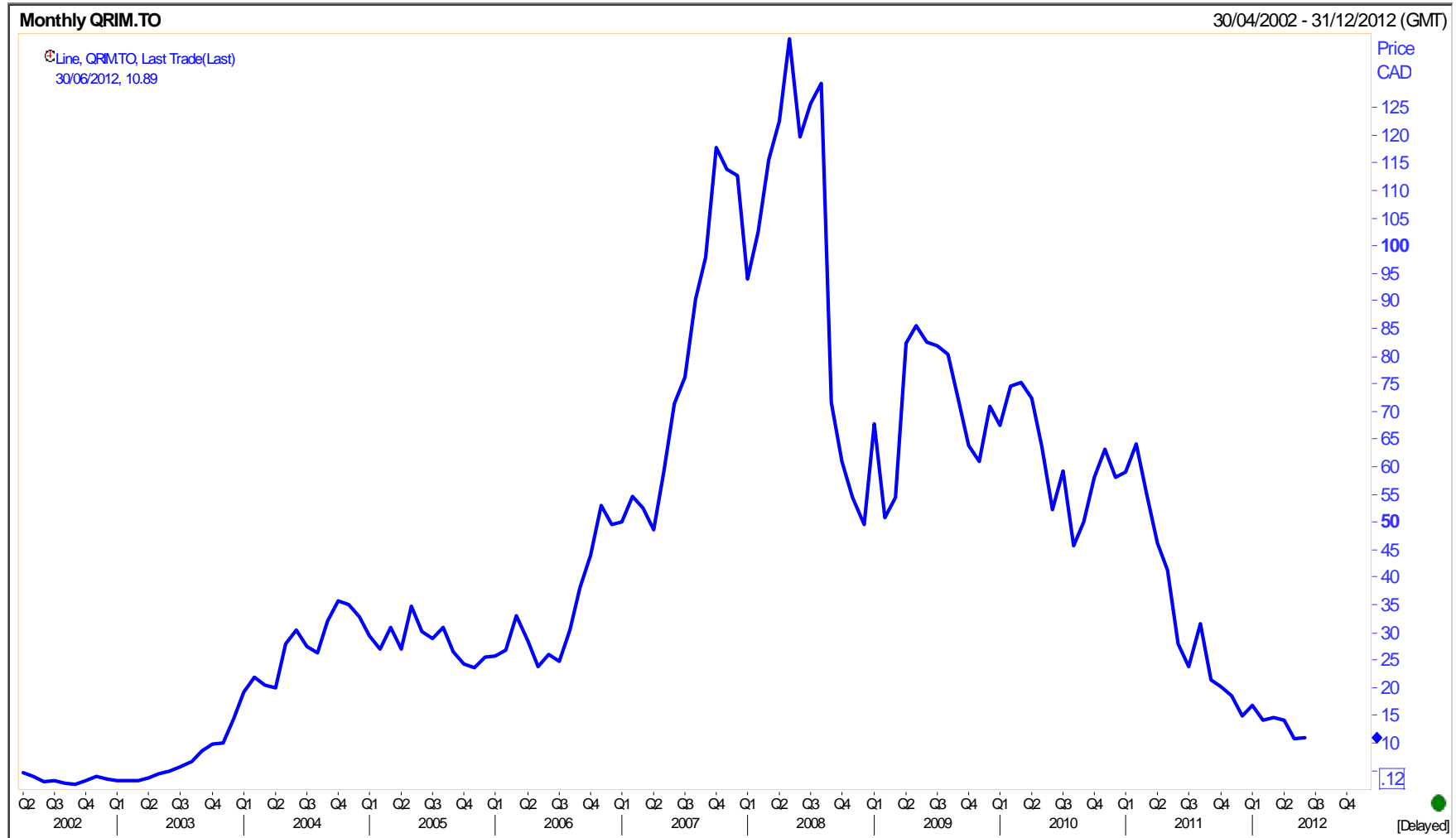
UK House Prices to Ave Earnings 1952 to 2011



Nokia 1990 - 2012



Research In Motion 2002 - 2012



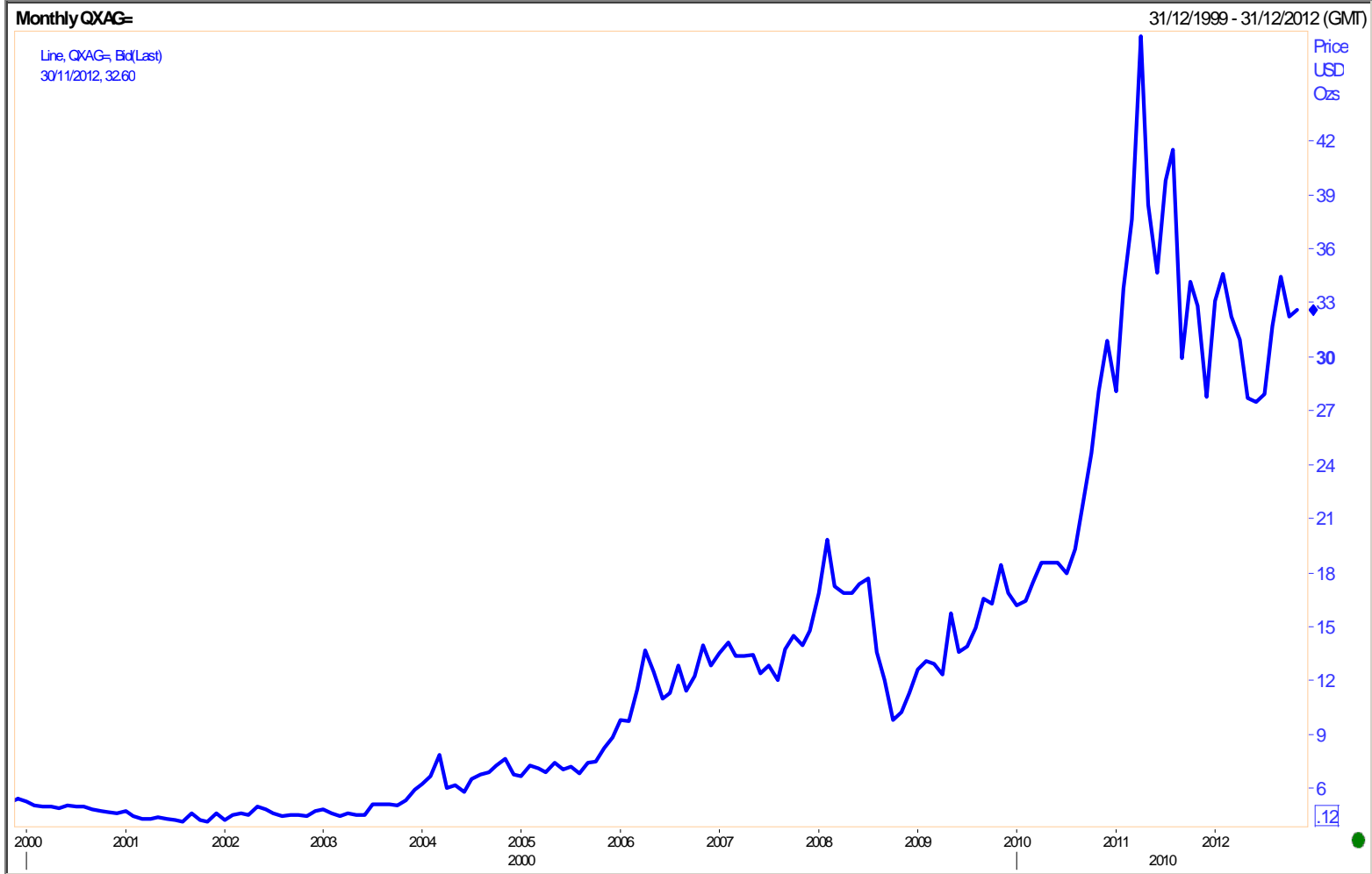
Are there bubbles today?

Where do you see speculation in the markets today?

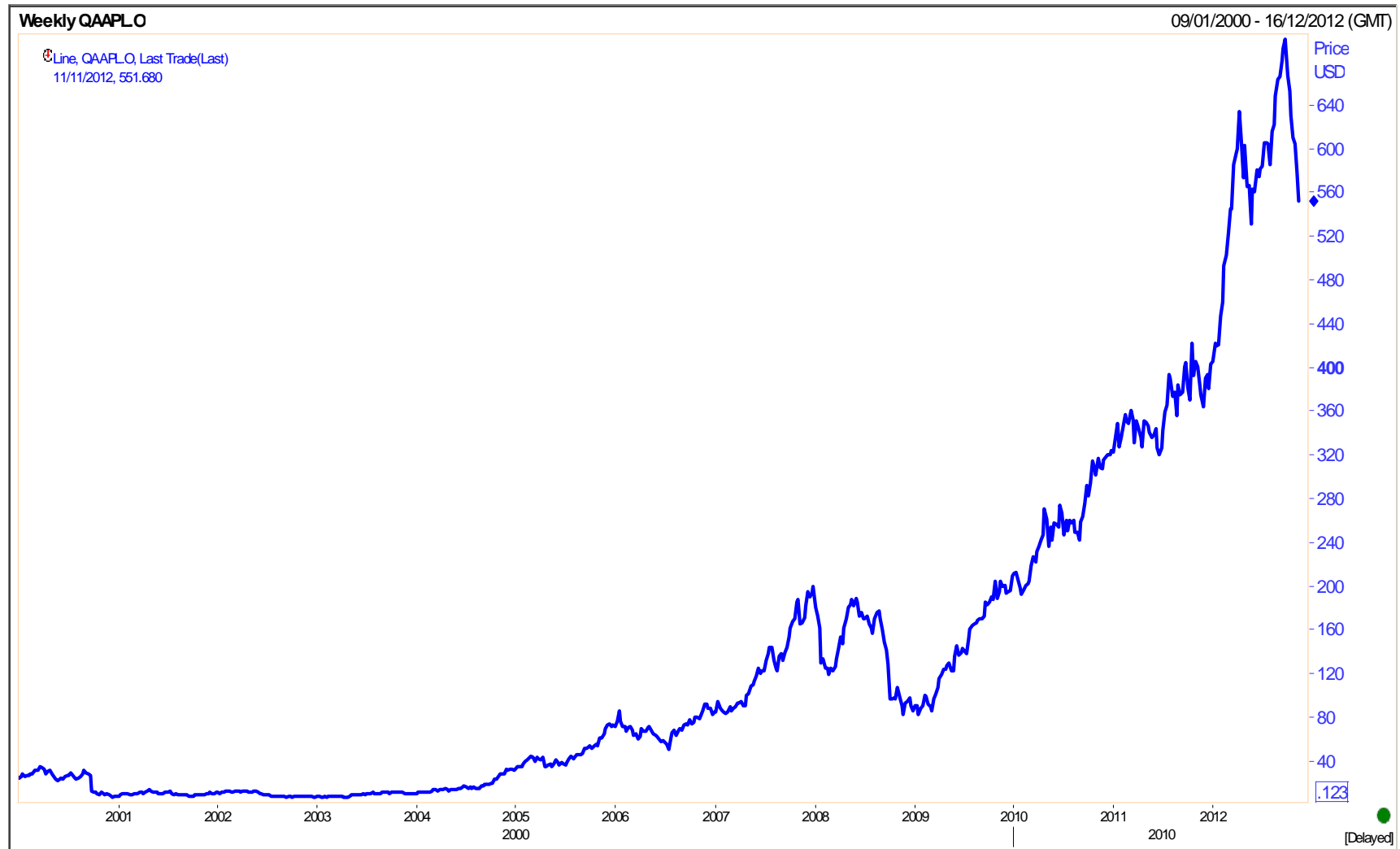
Clearly in the commodity markets.... They will not hedge oil. I can think of only one company that hedges its oil..... And very few will hedge the price of copper at US\$4 per pound despite that fact it has rarely been at this price. The cost of production is very low, so you can make a lot of money if you hedge your copper price. But almost no one will hedge today, and that is an indication of speculation.

We met people in China, even ordinary people, who owned three and four apartments. I would say to them, "If you sell one apartment, you'll have a million dollars, free and clear. And you'll still have three more apartments." All of these prices have gone up fourfold in four years. You know what the person says? She says, "I can't do that because I sold one two years ago and it doubled after that. So I am never doing that again."

Commodities - Gold



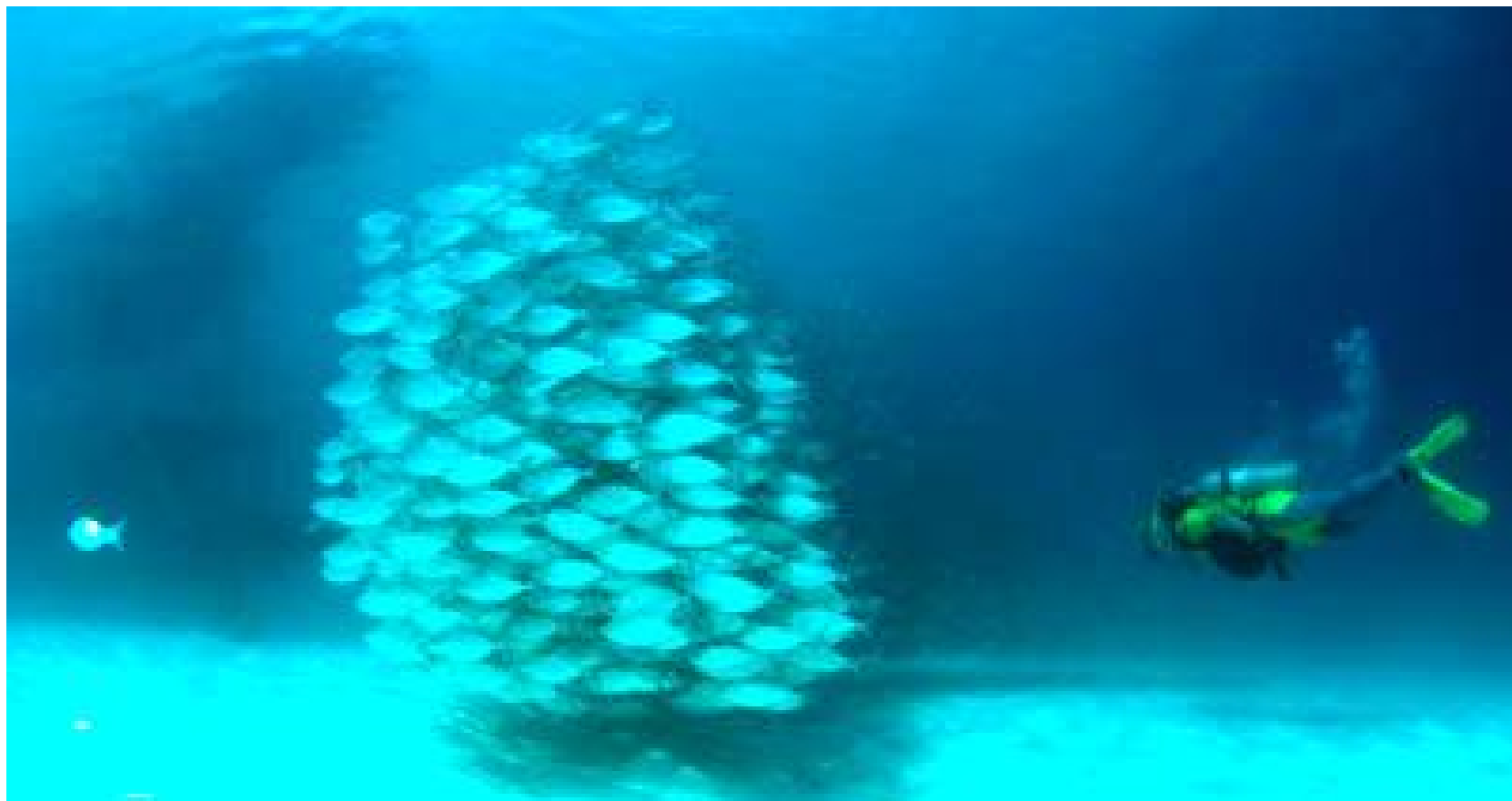
Apple 1990 - 2012



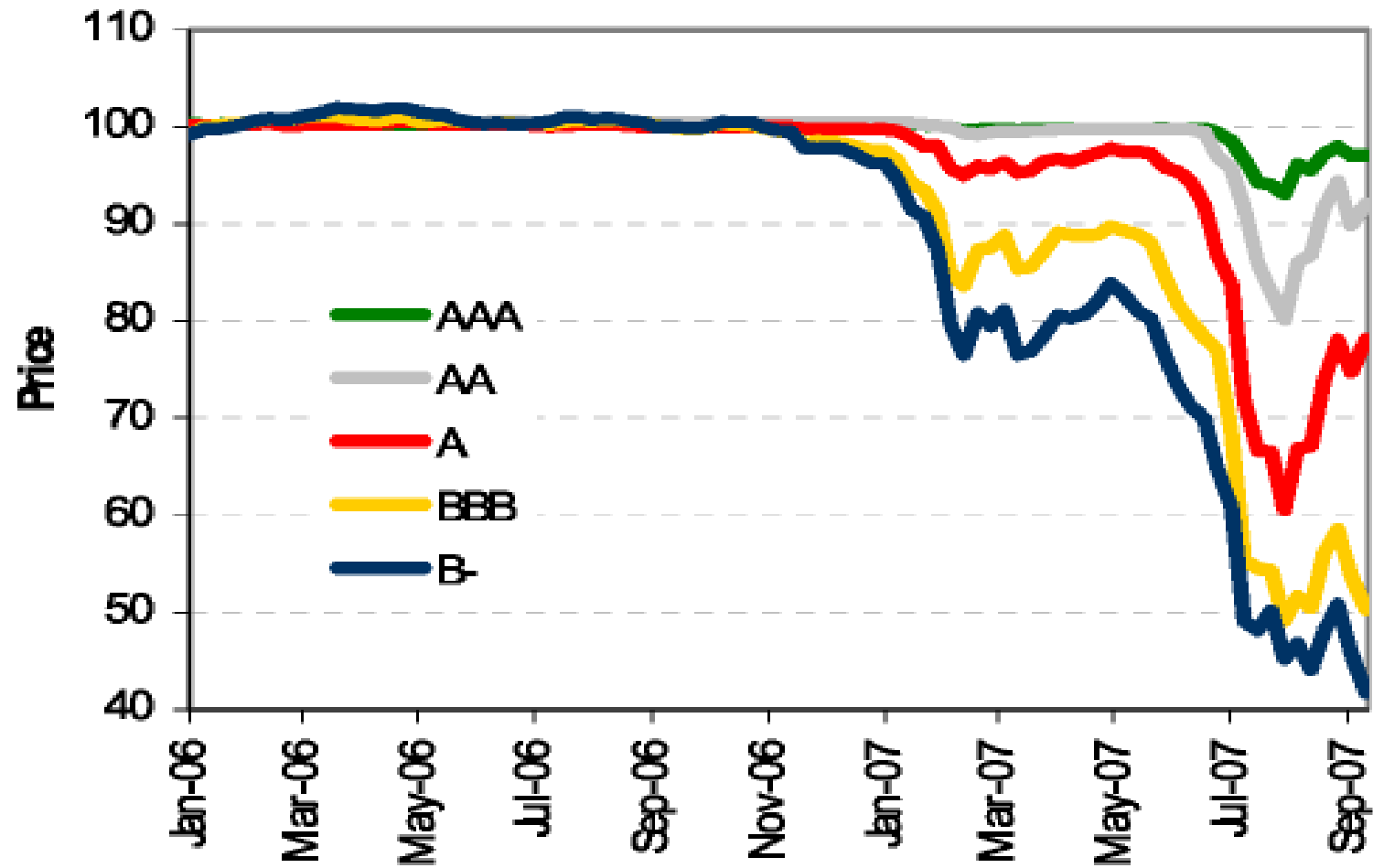
Key points

- Bubbles and crashes happen, contradicting market efficiency
- Behavioural finance explains this better, but not all
- Asset-backed securitisation bubble illustrates behaviour
- Cognitive errors and emotional biases are involved
- Behaviours typically individual, rather than herd mentality

Smart crowds



2006 Vintage Sub-prime – ABX indices



Smart crowds

- Diversity of knowledge about the available options
- Open and honest sharing of information about the options
- Independence in the members' evaluations of the options
- Unbiased aggregation of the members' opinions on the options
- Leadership that fosters but does not dominate the discussion

The only way to preserve the wisdom of the crowd is to protect the independence of individuals

Follow the crowd 60% of the time and spend the other 40% searching out escape routes of your own. – Fisher, The Perfect Swarm

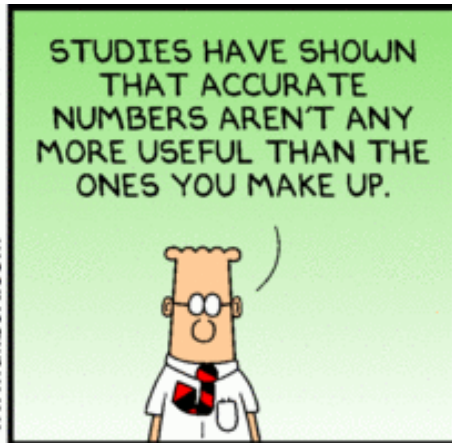
The illusion of precision

“If you say that there are elephants flying in the sky, people are not going to believe you. But if you say that there are four hundred and twenty-five elephants in the sky, people will probably believe you. ”

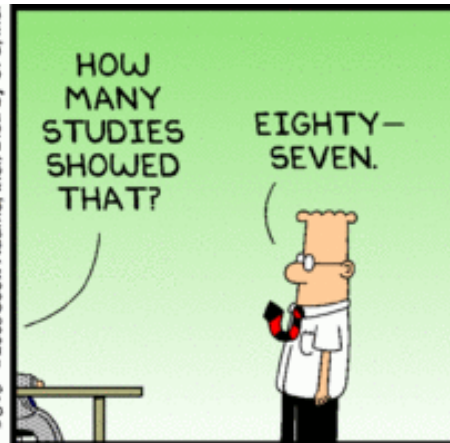
Gabriel García Márquez, Nobel Laureate



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Betas used by Professors

A survey with 2,500 answers

2,501	Answers
934	Institutions
160	Professors

Source: Pablo Fernandez, IESE Business School 2009

Precisely confident

Pelley: Can you act quickly enough to prevent inflation from getting out of control?

Bernanke: We could raise interest rates in 15 minutes if we have to.....

Pelley: You have what degree of confidence in your ability to control this?

Bernanke: One hundred percent.

"As you will be aware, the primary objective of the European System of Central Banks is to maintain price stability in the euro area. In the first part of my lecture I will show how the ECB achieved this primary objective before, during and after the crisis. I will also try to convince you that the economic performance of the euro area as a whole has been quite remarkable over the past twelve and a half years."

Mr. Trichet, London, 13/06/2011

Outcome of the stress test : with 2011 capital raising

- Adverse outcome with Jan-April 2011 capital raising:
 - 8 banks below 5% CT1
 - EUR2.5bn capital deficit below 5%
 - 16 banks fall in the 5%-6% CT1R range
 - CT1R from 8.9% to 7.7%

Dexia

Adverse scenario

	2010	2012	< 2%	< 3%	< 4%	< 5%	< 6%	< 7%	< 8%	< 9%	< 10%	> 10%
AT	8.2%	7.6%	0	0	0	1	0	0	1	1	0	0
BE	11.4%	10.2%	0	0	0	0	0	0	0	0	0	2
CY	7.7%	5.7%	0	0	0	0	1	1	0	0	0	0
DE	9.4%	6.8%	0	0	0	0	2	4	2	1	1	2
DK	9.8%	11.9%	0	0	0	0	0	0	0	0	1	3
ES	7.4%	7.3%	0	0	3	2	7	5	1	3	2	2
FI	12.2%	11.6%	0	0	0	0	0	0	0	0	0	1
FR	8.4%	7.5%	0	0	0	0	0	2	1	1	0	0
GB	10.1%	7.6%	0	0	0	0	0	1	2	1	0	0
GR	10.2%	6.1%	1	0	0	1	2	0	2	0	0	0
HU	12.3%	13.6%	0	0	0	0	0	0	0	0	0	1
IE	6.2%	9.8%	0	0	0	0	0	0	1	0	0	2
IT	7.4%	7.3%	0	0	0	0	1	2	1	1	0	0
LU	12.0%	13.3%	0	0	0	0	0	0	0	0	0	1
MT	10.5%	10.4%	0	0	0	0	0	0	0	0	0	1
NL	10.6%	9.4%	0	0	0	0	0	1	0	1	1	1
NO	8.3%	9.0%	0	0	0	0	0	0	0	1	0	0
PL	11.8%	12.2%	0	0	0	0	0	0	0	0	0	1
PT	7.1%	5.7%	0	0	0	0	2	2	0	0	0	0
SE	9.0%	9.5%	0	0	0	0	0	0	0	1	2	1
SI	5.7%	6.0%	0	0	0	0	1	0	0	1	0	0
Total	8.9%	7.7%	1	0	3	4	16	18	11	12	7	18

Why are experts often wrong?

- Misunderstanding probabilities
- Anchoring in initial assessments
- Faulty search processes
- Overconfidence
- Over-complexity / overfitting
- Biased incentives

Experts

- Watch out for spurious precision
- Be sceptical of too much explanation from expert
- Confidence can be failure to seek contrary evidence – confirmation bias
- Try to spot stories
- Examine biases / incentives
- Some answers should be “insufficient available information” or “don’t know”

Fukushima : expert analysis by UK's Chief Scientist

Situation at Fukushima nuclear plant 15 March 2011

The Government's Chief Scientific Officer Professor Sir John Beddington

In this reasonable worst case you get an explosion. You get some radioactive material going up to about 500 metres up into the air. Now, that's really serious, but it's serious again for the local area. It's not serious for elsewhere

If you then couple that with the worst possible weather situation and you had maybe rainfall The answer is unequivocally no. Absolutely no issue. The problems are within 30 km of the reactor.

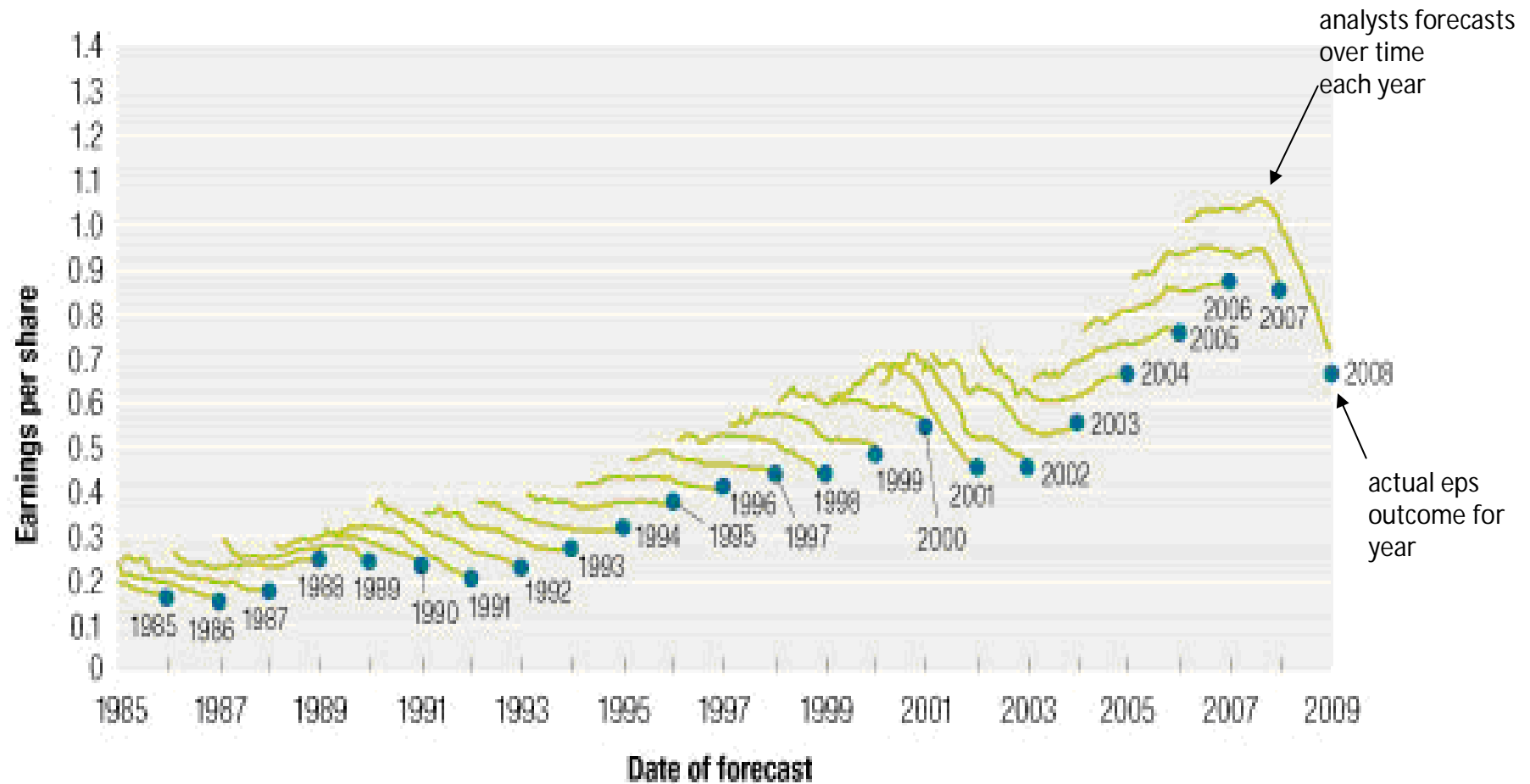
So what I would really re-emphasise is that this is very problematic for the area and the immediate vicinity and one has to have concerns for the people working there. Beyond that 20 or 30 kilometres, it's really not an issue for health.

Yes, one more question. Under the reasonable case scenario you've outlined, what sort of strength of wind would it take actually to carry radioactive material from Fukushima to Tokyo for instance? Is it just there is no strength of wind possible to do it? Or it is, are you assuming some kind of wind strength in your reasonable scenario?

[JB] No, no. The..... basically, it just won't happen.

Source: <http://ukinjapan.fco.gov.uk/en/news/?view=News&id=566799182>

Analysts' perpetual earnings optimism



monthly forecasts, S & P 500 Companies, eps in \$,

Sources: Thomson Reuters; I/B/E/S Global Aggregates ; McKinsey, SVM

Dealing with analyst biases in forecasting

- Incorporate underlying base rates
- Make explicit and unambiguous forecasts
- Document forecasts and decisions
- Prompt and accurate feedback
- Reward system that incentivises accuracy (not necessarily money)
- Appraisal by colleagues, superiors and systems
- Provide counter-argument
- Assign probabilities

Search processes

- Standardise process : systematic data collection
- Focus on metrics : collect comparable data
- Caution on descriptive or unverifiable data
- Be alert to framing / earnings adjustments
- Seek contrary facts and opinions
- Use online or systematic data gathering
- Incorporate evidence sequentially

What clients want to hear

Conviction
Core
Long-term

Selective
Quality
Fundamental

“... hopes quality stocks can turnaround performance”

“... is convinced better-quality companies will be rewarded in 2012”

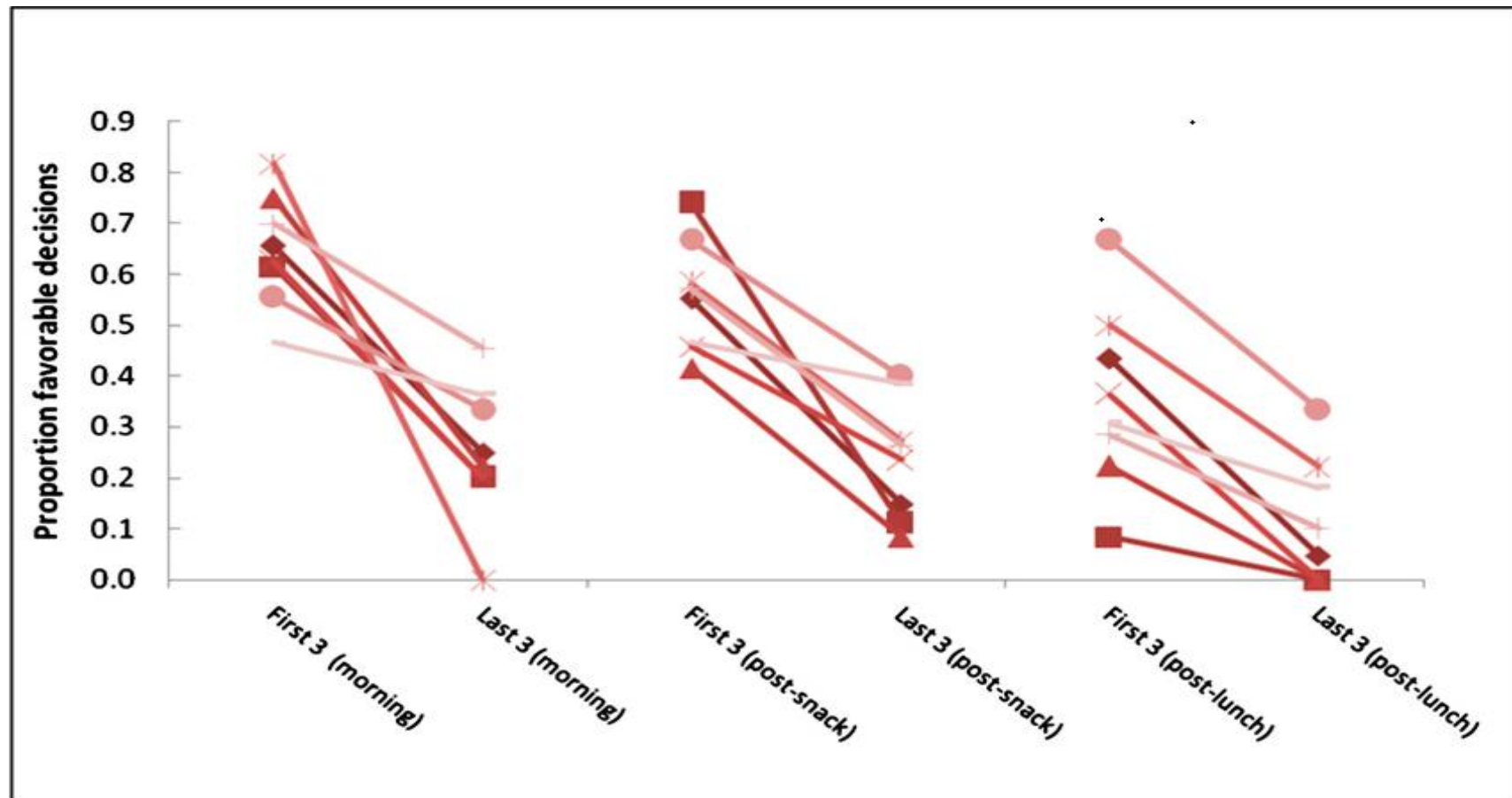
Many investors believe risk and return are negatively correlated – *representativeness*. Higher returns expected from “better companies”

Addressing behavioural issues : teams

- Collect privately-held information in advance
- Collect disconfirming evidence
- Record assumptions and base rates
- Document decisions and reasons
- Review previous decisions

Repetitive task problems

The proportion of favorable decisions as a function of judge and ordinal position within a session. The data points reflect proportions for the first three versus last three decisions in each of the three sessions, for each judge. On average a data point reflects 16.00 decisions



Memory fails us

- Hindsight bias – prevents us learning from the past
- Fundamental attribution error
- Emotionally significant events distort memory
- Inattention blindness – fail to recognise some factors
- Egocentric bias – we edit our memories

It's a poor sort of memory that only works backwards

Reviewing the record

- Derive rules and checklists
- Understand how situation presented itself
- Why did decision make sense?
- Pain of regret reinforces learning
- Audit decisions – but don't oversimplify causality

Hindsight bias allows us the illusion of control

What to document

- Key questions and concerns
- Contrary information & less salient facts
- Situation and context; mood
- Choices – alternatives
- Consensus
- Expectations – exit strategy

Thank you for your attention



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