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Behavioural Finance

Investors
An article I came across recently intrigued me, an area I has not heard before, so I thought I would share it with you.

I am summarising some of the research but have shown the link if any would like to see the full article.

The link is:

http://au.pfinance.yahoo.com/b/andrew-page/59/investors-behaving-badly

One of the most exciting and fastest growing areas of research is in the field of Behavioral Finance, which seeks to understand how we approach investing by applying the lessons of psychology. While most other economic schools of thought assume that investors are rational, sensible and well informed, behavioral finance acknowledges that we are emotional beings who often exhibit impulsive, irrational and sometimes self destructive tendencies. (For those who are interested in a more detailed review, I highly recommend the book "Behavioral Investing: A practitioners guide to behavioral finance" by James Montier).

Below are some of the more common biases we tend to exhibit as investors.

Short term focus
This means that we often opt to lock in small profits today rather than allowing our investments time to grow into something more substantial. Furthermore, it means we are easily scared off by short term losses even if there has been no fundamental cause for alarm.

Herd mentality
We are all hard wired to go with the flow. Although it has been repeatedly demonstrated that the best time to invest is during periods of great pessimism and the best time to sell is during periods of unbridled optimism, the vast majority of us do the exact opposite.

Overconfidence
It is easy to demonstrate that most novice investors tend to fare very poorly, but this fact does little to discourage people from diving head first into the markets with little understanding or planning. The lesson here is to remain as realistic as possible, and don't fool yourself into thinking that you have special abilities above that of the ordinary person.

Heads in the sand
We all love to hear things that agree with our own opinions and reinforce our beliefs. More importantly we loathe anything that disagrees with our outlook and tend to dismiss it as unimportant, or often simply wrong. The truth is that we do ourselves a serious disservice by ignoring information purely on the basis that it disagrees with our own view. Investors who limit themselves in this way are destined to fail at evaluating events in an objective and considered fashion.

A focus on the irrelevant
Many people base their investment decisions on price alone, while others look to the heavens and use astrology as the basis for their decisions. Investors would do well to ignore any investment style or technique that is not strongly supported by evidence.

I know best
Many experiments have shown that we tend to give more weight to our own experiences than we do to the experience of others, or even rigorous statistical evidence. The truth of course lies somewhere in between these two extremes, but few people are accepting of evidence that does not agree with their own experience.

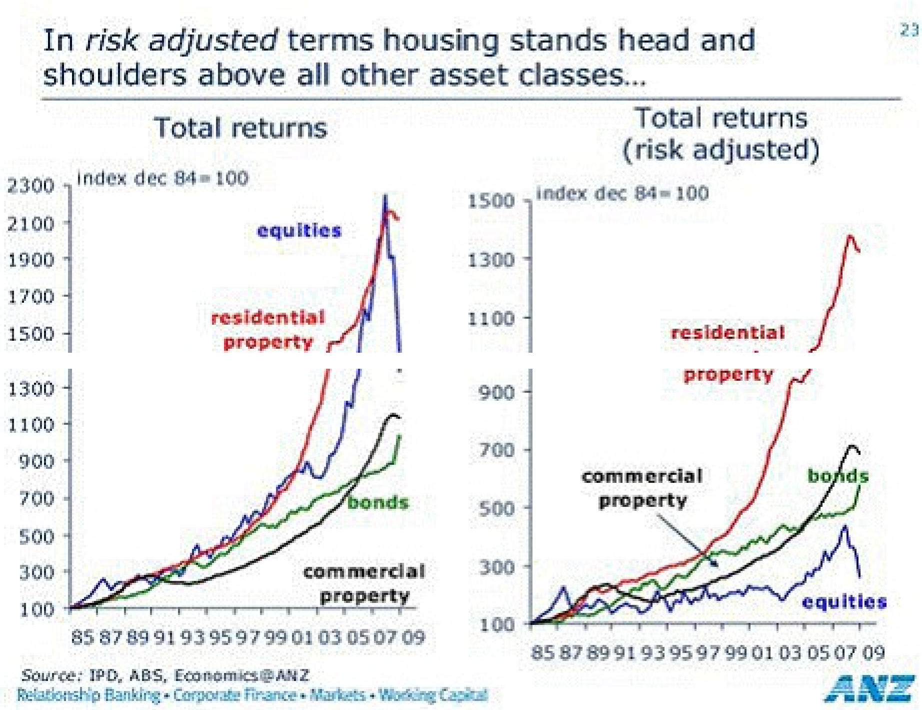
The endowment effect
It seems that ownership tends to drastically distort our perception of value. Smart investors do not become emotionally attached to their shares.

We cannot change the fact that we are emotional beings, and nor would we want to. The point is that investment decisions should be driven primarily by reason and objectivity. That is, although it may be easier said than done, you should invest with your head, not your heart. The best way to do this is to establish a very clear strategy prior to entering the market. Map out in advance what it is you are looking to achieve and have a clear plan of action to respond to all likely scenarios. This way you will never be taken by surprise, and will be less likely to act irrationally and emotionally.

Risk Return Comparison

I know I have sent through this graph in a previous e-mail but it may help reinforce part of the reason why residential property is an attractive asset investment vehicle, it is the risk return that Banks so well understand. My view is that to create long term wealth, you need to concentrate on the finance component of the investment decision and then use an asset class that lenders are willing to lend on. While Banks have reduce their lending ratio's with most dropping from 100 or 95% loan to value ratio (LVR), they have only dropped to 90%. They will still lend money at a 90% LVR, meaning you can leverage you own funds by 9 times. You need a firm strategy and have a large safety net and risk insurance in place to feel comfortable and to sleep well at night.

Combine this with the research findings above reinforces the view that a smart investor has a long term strategy and a clear action plan, they view the evidence, they build a team of experts around them that will help them achieve their goals and their decisions are based on logic and numbers.



This graph on the left also shows that Equities (or shares) have performed almost equally with residential property up until late 2007 and then gone into free fall while residential property has fallen marginally (based on median prices). Irrespective of the Bad News headlines and some outrageous claims of the property market falling by 30 or 40%, it has not happened in Australia. The evidence as shown on the graph on the right clearly shows the returns from this asset class well and truly outperforms all other asset classes on a risk return basis and that is why Banks are still lending at 90% LVR's. They have the confidence that the market will not fall irrespective of what you or I may individually think.

Our Service to You

We provide a specialised service for investors wanting to create long term wealth for themselves and their families. We are finance strategists, credit advisers and mortgage brokers, helping you achieve your goals. Give us a call when you think it's time to consider your options.

As well as providing a service to investors, we will assist you in purchasing as an owner-occupier, or upgrading to a new property, or simply looking at better pricing or structuring options for your current loans and banking or assisting seniors looking at possible reverse mortgage options.

Our business is built on referrals provided by clients, so please don't keep us a secret, feel free to forward this e-mail to family and friends interested in their own financial future. Give us a call and book an appointment to see if it makes sense for you.

If you have any questions about any of these topics, give me a call.

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