Trading behaviors

By **Clare Flynn Levy**, founder & CEO, **Essentia Analytics**

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Clare Flynn Levy is founder & CEO of Essentia Analytics, a financial software company that uses behavioural data analytics to help professional investors do more of what they're good at and less of what they're not. Prior to founding Essentia, she spent 10 years as a fund manager, both active equity (running over $1bn of pension funds for Deutsche Asset Management) and hedge (as founder & CIO of Avocet Capital Management, a specialist tech fund manager).

Traditionally, the New Year is a time for taking stock and making resolutions we hope will improve the choices we make over the next 12 months. Often, those resolutions are about self-discipline such as: "I'll go to the gym three times a week". Active investors may find themselves making similar pledges regarding their investment decision-making: "I won't trade around so much."

Making resolutions is, of course, the easy part. Where we tend to fail is in their implementation. Cognitive science has now proved that our habits are deeply entrenched behaviours which demand not just resolve, but an applied approach, before they shift.

Starting with the academic work of Kahneman and Tversky, behavioural science has revealed that our everyday actions and decision-making performance are affected by an unconscious interplay of intuition, emotions and our physical state. 'Biases', some rooted in millennia-old instincts of greed and fear, can be triggered unhelpfully - often in stressful situations - causing us to act in systematically irrational ways.

The increased interest in the field of Behavioural Finance is evidence of the widespread realisation that unconscious bias can be particularly damaging to investment decision-making (with mirror opportunities to preserve alpha by mitigating its effect).

Professional investors, traditionally used to considering the opportunities created by irrationality of others, are now confronting the range of biases that can detract from their own skill in forming investment decisions. The industry is finally internalising the wisdom of investment greats like Benjamin Graham, who said "The investor's chief problem - and even his worst enemy - is likely to be himself."

Do you exhibit behavioural bias in your investment decision-making? The near-certain answer is yes. Ultimately, there is one way to find out: analyse your past trading behaviour and the reasons behind it. In the meantime, some of the following may sound familiar:

A common cognitive tendency displayed by investment professionals is **outcome bias** – judging a decision by its eventual outcome, instead of by the quality of the decision at the time it was made. An investment can do well, but not necessarily because the initial hypothesis was correct. Buying and selling at the right time for the right reasons is rarer than many professionals would admit.

Loss Aversion is what leads us to avoid risk when gains are at stake, but seek risk when losses are at stake. A classic example: Which would you rather do: take $100 now, or take a bet where there's a 50% chance you'll win $0 and a 50% chance you'll win $200? Ok, now, which would you rather do: give us $100 from your pocket now, or take a bet where there's a 50% chance you'll lose $0 and a 50% chance you'll lose $200? Loss Aversion is what leads most people to take the $100 in the first scenario and take the bet in the second one.

The **Disposition Effect** is very common amongst both professional and amateur investors. An expression of Loss Aversion, it's seen where we run our losing positions too long, and cut our winning ones too soon. Research to measure the Disposition Effect has shown that winners sold outperformed those losers retained by an average excess return of 3.4% per annum (Odean, 1998).

Herding is one of the most cited biases – so common it needs no explanation here. Of its impact on performance, Howard Marks of Oaktree Capital Management wrote in 2006: "Herd followers have a high probability of achieving average performance, but in exchange for safety from being much below average, they surrender their chance of being much above average."

Analysts and brokers can act as an emotional comfort blanket, as much as a source of rational information and research. Speaking to a large number of brokers can be a symptom of **Information Bias** (the tendency to seek information even when it cannot affect action). Does the tenth broker really bring anything new to the table?

A growing number of professional investors are now achieving the performance gains that can come through mitigation of behavioural biases such as these.

But this process starts with an exploration and recognition of where they exist.

So, this year, add some science to your resolutions; resolve to keep a structured and honest record of the why behind each of your investment decisions - for your own personal, private use. You might be surprised what you find out about the way you make decisions.

And that could prove to be the most valuable information you get your hands on all year.