

# The human decision-making processes\*

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## C. Thomas Howard Behavioral Portfolio Management

*UK: Harriman House Ltd., 2014, p. 324*

*ISBN-13: 978-0857193575*

Similarly to other fields of study, the theoretical history of capital markets and portfolio management can be viewed as the history of a succession of paradigms; the past 80 years have been shaped by two consecutive schools of thought, with a third one currently emerging. *Graham and Dodd's* 1934 book *Security Analysis* was seminal in laying the foundations of fundamental analysis, the first systematic approach to capital market analysis and investment. *Graham and Dodd* argued that it was possible to build superior stock portfolios using careful fundamental analysis of corporations and by identifying the price distortions caused by emotionally-driven investors.

The ascendancy of modern portfolio theory in the 1970s came to replace this approach, which agreed that there were many emotional investors, but argued that there were enough rational investors to arbitrage away pricing mistakes (by achieving risk-free profit). If the market is ruled by rational expectations, then market prices are efficient, in other words, they reflect all available public information. Fundamental analysis is pointless on efficient markets. In the context of this framework, active portfolio management does not yield higher returns in the long run, and investors are advised to follow a passive, index-tracking strategy, which is cheaper to implement.

A study of human decision-making processes did not corroborate the rational expectation hypothesis and found that emotions and heuristics dominate decision-making. Behavioural portfolio management is an approach that bases its initial assumptions on this observation.

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\* The views expressed in this paper are those of the author(s) and do not necessarily reflect the official view of the Magyar Nemzeti Bank.

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Two investor groups can be identified on this basis: the emotional crowd and behavioural data investors, the latter essentially being rationally thinking actors. The emotional crowd consists of investors basing their decisions on emotions and intuition, that is, on *Kahneman's* System 1: automatic and quick short-term thinking with no effort or control, social validation and acceptance, and loss aversion hardwired into us by human evolution. By contrast, behavioural data investors conduct thorough and comprehensive analyses of the available data prior to making decisions, representing the System 2 mode of thought consisting of conscious thinking, where effort and complexity prevail.

The first principle of behavioural portfolio management is that the emotional crowd dominates market price developments, while fundamentals only play a more minor role. The basic difference between modern portfolio theory and behavioural portfolio management lies in their assessment of the efficiency of arbitrage. If arbitrage is not efficient, price distortions may be lasting in nature, in which case active portfolio management can yield superior quality and more profitable portfolios compared to simple index tracking.

The second principle of behavioural portfolio management is that behavioural data investors are able to achieve higher returns. This principle seems to stem logically from the first basic principle, but assuming positions that run counter to the emotional crowd is challenging for investors due to their own emotional barriers. Public opinion holds that an average equity fund is unable to achieve excess return over the long run; research, however, shows that actively managed mutual funds are successful in identifying highly performing individual shares: the most overweight stocks yielded substantial excess returns.

Behavioural portfolio management's third principle posits that investment risk is nothing other than the chance of financial underperformance. Modern portfolio theory uses volatility, that is, the deviation of investment returns to analyse investment risk. This indicator, however, is much more an instrument for quantifying emotions as opposed to investment risk. Instead, investment risk should be regarded as the risk of financial underperformance. The chance of underperformance depends on the investment's time horizon: volatility is a real risk for short-term investments, while short-term price fluctuations are less important for long-term investments.

The author reviews the cult of emotion: the myriad of emotional barriers within us, such as myopic loss aversion, and the fact that modern portfolio theory reinforces these emotions and consists of emotional catering. *Howard* also argues that emotionally driven decision-making is the main obstacle to successful investment and financial decision-making. A common example of this is the volatility trap, in which investors sell their investments when equity prices fall and volatility increases, driven by fear of loss and thus losing out on the profit harvested on subsequently rising prices once the equity market "heals itself".

The book includes a practical twelve-step programme to overcome emotional brakes and mitigate emotional costs, in other words, to abandon the “cult of emotion”.

The author argues that behavioural data investors, devoid of emotional barriers, are able to invest more successfully by consistently implementing a narrowly defined strategy and by taking high-conviction positions instead of using Markowitz’s mean-variance optimisation proposed by modern portfolio theory. The multileveled system of narrowly defined strategies is based on an estimation of unobservable behavioural factors using proxy variables. Taking high-conviction positions refers to implementing the portfolio manager’s best ideas as opposed to over-diversification, i.e. emotional catering to customers. Consistent implementation means complying with a dynamic and intelligent classification system instead of the using the current static industry standard style box.

*Howard* is hopeful that the 2013 Nobel Prize split between *Eugene Fama*, a supporter of the efficient market hypothesis, and *Robert Schiller*, an opponent of the hypothesis (and *Lars Peter Hansen*) will spark debate leading to a paradigm shift that will see rationality replace emotions.