Understanding Behavioral Finance

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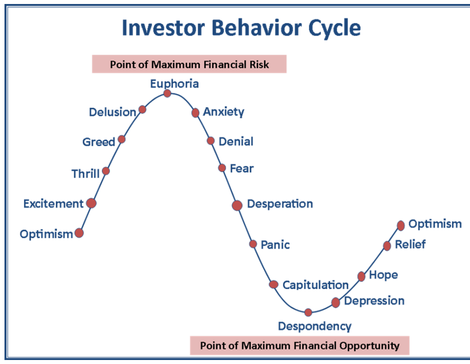
A "New" Approach?

SEM Wealth Management

After Richard Thaler won the Nobel Prize in economics in 2017, behavioral finance was suddenly a focus for many investment management firms. Most acted like this was a new approach, probably because Dr. Thaler's work was much easier to understand than past Nobel Prize winners following the same discipline. In 2013 Robert Shiller won the Nobel Prize for his work on "irrational exuberance". He was written off by most as the "bubble" guy with few on Wall Street wanting to pay attention. The birth of behavioral finance can actually be traced back to Daniel Kahneman and his research partner Amos Tversky. Dr. Kahneman won the Nobel Prize in economics back in 2002 for his work on how humans process information and make complex decisions. The interesting part about Dr. Kahneman winning this prize was he was not an economist, but a psychologist.



There is a key distinction between traditional and behavioral finance explained by these three Nobel Prize winners — traditional finance looks at what people SHOULD do, behavioral finance looks at what people WILL do.

"The stock market is a story of **cycles** & of the **human behavior** that is responsible for **overreactions** in both directions."

- Seth Klarman

Since our founding in 1992, SEM has observed the consequences of emotional reactions. Every trading system inside every investment model is designed to help mitigate the damages that can occur when we allow our emotions to control our decision making.

Critical Research Supporting Behavioral Finance

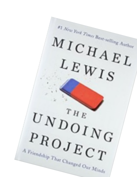
The two psychologists, Dr. Kahneman & Tversky's work centered around how the human brain works. Through hundreds of clinical tests they discovered our brain has two decision making components—the fast brain and the slow brain. The fast brain is your "instincts" or things that do not require much thinking. It was originally thought the slow brain was a workhorse, but their tests showed the slow brain is lazy and uses heuristics, or mental short-cuts to make decisions. Through this Kahneman & Tversky identified dozens of behavioral biases that impact our ability to make wise decisions.

Dr. Thaler, who had studied under Kahneman & Tversky felt uncomfortable with some of the theories economists were using. He started a list of things humans did that did not match what economists said they would. Through this and a long series of tests he learned while economists assume all people will behave rationally, in reality humans tend to behave in a way economists would call irrational.

Reading List

If you want to learn more about behavioral finance we would recommend the following (in order)

- *The Undoing Project*, Michael Lewis
- *Misbehaving*, Richard Thaler
- *Thinking Fast and Slow*, Daniel Kahneman



For more information go to:

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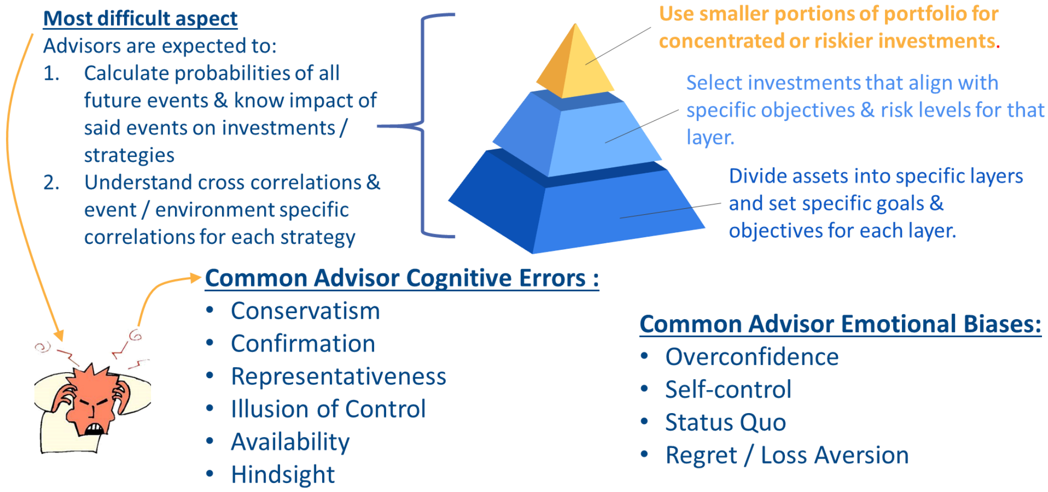
SEM's Behavioral Approach centers around creating a plan customized to meet the needs of the individual investor. The foundation of this is a complete financial plan and cash flow strategy. SEM's role begins with the investment plan. Given the unlimited number of investment allocations that can be generated, this is the place many of the heuristics (mental shortcuts) identified by Dr. Kahneman come into play. Improper execution of this phase of the plan can cause the client to not stick to their financial plan.



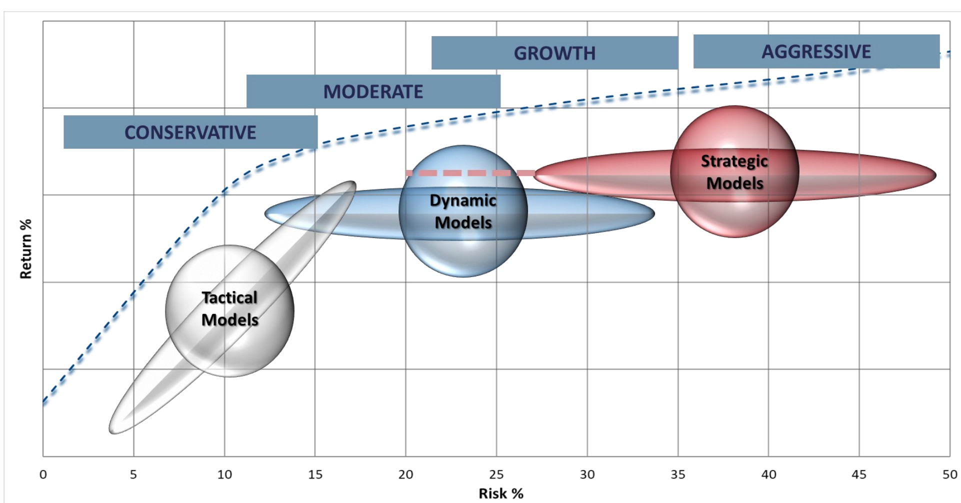
Using Behavioral Tricks to Create Customized Portfolios

Over the long-run stocks should out-perform nearly every other investment out there. Because of this we know investors SHOULD stay invested in stocks for the long-run. Studies have shown most investors will not stay the course as they are likely to react emotionally at some point in their investment journey.

A behavioral approach to investing adapts investment portfolios to what investors likely WILL do. Each investor has their own specific biases, but generally speaking those biases can be grouped into categories. Conservative investors all tend to have certain biases, which will be different than Growth investors. This means investment portfolios need to be allocated differently for each type of client.

This goes far beyond the typical stock/bond portfolios used in traditional finance. A behavioral approach uses distinct management styles and asset "buckets" to "trick" our brains into doing what we SHOULD be doing. It may not be the perfect approach on paper, but the goal is to make sure the investor sticks to the long-term plan.

In addition, a behavioral approach demands different styles of communications at different parts of the market cycle for the various investor types. The upside is rather than constantly telling clients what they SHOULD be doing, a behavioral advisor will spend more time working on the long-term financial plan.



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