



Linking psychology and economics

Investing is not just about shrewd decision-making but also the emotion one feels when making that investment, writes Emma Kennedy

Contrary to popular belief, investing is not rocket science. It boils down to a simple concept: buy when the price is low and sell when the price is high to make a profit. Even the most complex investment product or structure comes down to the same simple goal – generate a return. But if it's really that simple and logical, why are we all not millionaires?

This simplistic view is based on an assumption of a rational world where all investors assess decisions in the same way and take the same actions to produce the optimal result. Alas, reality is a little less neat, and a lot of factors play a role in the choices of individual investors.

When subjective views come to bear on investment decisions, instinct can sometimes contradict theory. Michael Dowling, a former Trinity College researcher who now works as a finance lecturer at the University of Central Lancashire, said financial theory had traditionally been driven by people with a mathematical background. "They weren't equipped with psychological training, so they made a lot of assumptions that made their maths easy for them. Essentially, they assumed that people act like robots," he said.

Dowling is one of a new breed of modern academics who research how psychology and economics interact to try and identify how people actually make investment decisions. Research shows a difference between what investors and consumers say they'll do when making choices and what they actually do, so behavioural economics is a growing field of study.

Liam Delaney, a senior research fellow at University College Dublin's Geary Institute, and Ireland's representative on the International Association for Research in Economic Psychology, said psychology mattered most when uncertainty was greatest. "Emotion definitely matters more when things are more uncertain. People become more emotional and it affects their investment patterns," he said.

"When people feel good, they tend to overshoot the upside," Delaney said. By the same logic, investors who are worried or nervous could hang onto losing stocks for longer than they should.

In Delaney's view, the psychology of in-

vestment is as much about group dynamics as it is about an individual's subjective decision. "The other thing is herding. It leads to much more volatility in markets than people making independent decisions," he said.

However, sometimes what seems irrational can be the rational choice, with Delaney saying that following the herd can sometimes be the most logical course.

For him, the crux of the matter is being able to read sentiment. "The skill of winning the game is figuring out what other people think," he said. By this approach, investors may choose a course of action that seems irrational based solely on their own logic but, when viewed against the broader context of how the market looks set to move, this decision actually proves the most rational choice.

Dowling cites the example of how professional investors behaved during market bubbles, such as the dotcom boom, when hype prevailed. "Professional traders must have known they were investing in something that was overvalued, but decided the best way to profit was to 'ride the wave'. They didn't cash out in 1997, 98 or 99 when they would have known the same thing, but stuck with the bubble right until before the crash. In this case, it was rational for them to be irrational," he said.

While both pros and amateurs are subject to emotion, Dowling feels that less-experienced investors are more likely to be driven by their emotions. He said inexperienced traders faced greater uncertainty when making investment decisions because they didn't know as much about investment. "A lot of psychologists have shown that the level of uncertainty faced by people can be a determinant of how much they rely on their emotions. Essentially, these inexperienced traders are incapable of making decisions rationally, so they allow their mood and emotions to guide them."

But Dowling said even the professionals could be subject to psychological bias. "It's important here to not let professional traders off the hook as being the sane ones. There is a whole bunch of research showing that professional traders differ from inexperienced traders only insofar as they are less rational – not that they are perfect investors," he said.

As researchers delve into what makes us tick as investors, models and theory are being adapted to bring psychology into the mix. Brian Lucey, associate professor of finance at Trinity College, said: "Finance in particular is doing its best to incorporate these challenges into the theory and trying to evolve it."

But drawing together traditional models and new concepts is difficult. "It is hard to crunch the numbers – you are looking at something that is inherently immeasurable," Lucey said.

As a result, it is hard either to prove or disprove the extent to which emotion plays a role in investment decisions.

In Lucey's view, emotion is just one of

the factors. Things like gender, location and even the weather can affect our investment decisions. "My reading of the situation is that we are all subject to bias. But even when we know that we have these biases, it is extremely difficult to overcome that programming," he said.

While markets and investors may not always be rational, Lucey said that emotion was a necessary part of investing. "People who don't have emotions cannot make effective decisions – emotion is the tie-breaker between two rational scenarios."

The seven deadly sins

When the heart rules the head, investors can make mistakes that end up costing them money.

1. Sloth

Trading too much can end up costing you a lot of money, given the commission payable on each trade. Holding onto stocks can prove more beneficial in the long run.

2. Lust

Many people base investment decisions on their admiration of a particular company, rather than on a financial assessment of the company's fundamentals. Investing based on image alone will not serve you well.

3. Envy

Following the crowd in a burst of over-confidence creates bubbles. No one wants to miss out, so everyone piles in and share prices rise, but the value is purely notional, meaning the stocks are overpriced relative to the fundamentals that underlie them.

4. Anger

When reason falls and you pursue one course with dogged determination, you overlook one of the cornerstones of investment theory – diversification. Try to put passion aside in favour of a more balanced investment approach.

5. Pride

Cut your losses and don't be afraid to admit you made the wrong call if it means getting out with some of your investment intact. An irrational belief that a junk stock will rebound will cost you dearly.

6. Greed

Using historical prices to determine future prices is largely futile. Following share price trends generally means you are buying overpriced stocks, which then tend to underperform in the future.

7. Gluttony

Erasing the past from our memory and overindulging in stock market crazes is a common investor mistake. Learn from history and abstain a little when it comes to the next big thing.

*This panel is based on a paper entitled **The Seven Deadly Sins of Investing**, published by Michael Dowling and Brian Lucey in 2006*

