A STUDY ON ROLE OF BEHAVIOURAL FINANCE IN ACTIVE MANAGEMENT AND INVESTOR'S EMOTIONS

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ABSTRACT

Most investors need to have a certain amount of money at a certain time, and they can afford to contribute a certain amount towards that goal. Clearly, managing investors to reach their goals requires understanding the individual and how they will react to volatility, uncertainty, or the latest news story. One important piece of the puzzle is developing an understanding of behavioral finance. In short, the discipline can help us understand that people are emotional creatures, prone to delusional bouts that produce over-confidence, fearfulness, confusion, and potentially impulsive mistakes or extreme reticence. This paper discusses the advantages of active management and the limitations of the argument related to active versus passive investing. Further, it defines the fundamental reason for portfolio management, which is meeting the investor’s objectives—rather than beating the market. Importantly, it highlights the requirement to keep the investor’s emotions in check, to help them avoid making decisions that will inevitably limit their ability to meet those objectives. Finally, it focuses on the role of active management in robust diversification.

Keywords: Behavioural Finance, Active Management, Investor’s emotions, Portfolio Allocations.
INTRODUCTION

This paper discusses the advantages of active management and the limitations of the argument related to active versus passive investing. Further, it defines the fundamental reason for portfolio management, which is meeting the investor’s objectives—rather than beating the market. Importantly, it highlights the requirement to keep the investor’s emotions in check, to help them avoid making decisions that will inevitably limit their ability to meet those objectives. Finally, it focuses on the role of active management in robust diversification.

ACTIVE OR PASSIVE: IS THAT THE QUESTION?

For many years, the media, economists, analysts, academics, and investment advisors have been participating in a school-yard argument about the virtues of their chosen opinion. “Active is better! No, passive is better. Yeah? Prove it. No, you prove it!” More often than not, this back and forth goes on without a clear definition of what active management actually is.

With access to sufficient computing power and terabytes of data, we can, of course, find ways to “prove it.” Clearly, humans are very adept at finding what they need to corroborate their strategy or methodology while conveniently brushing aside data that may cast a shadow on their cherished beliefs. Much of the active versus passive argument has centered on “beating the market,” with active investment strategists making the case that staying out of the market during downturns—and jumping in at the bottom to ride the upturns—enables them to beat the market, while the buy and hold, passive investment pundits insist that “if you missed the 10 best days in the last 10 years” you would have small or even negative returns—basically arguing that timing the market is impossible.

This whole line of reasoning misses the point. It’s not about beating the market. Simple arithmetic tells us that most investors will not consistently beat the market. It’s fundamentally about enabling investor to meet their financial objectives, which involves allowing them to stay comfortably invested in all market environments. We contend that active management is an important tool in meeting that goal and provides additional diversification—enabling you the opportunity to improve performance and smooth market volatility.

Not to spoil the ending, but we may never be able to prove anything. Why? Because markets, economies, political and social landscapes are ever-changing—and they are all influenced by people whose decisions impact those ecosystems. This is like the world’s largest Rubik’s cube. While in the aggregate we generally treat markets as rational systems, in practice, people make decisions based on emotion and unforeseen events that change their life circumstances—which often have nothing to do with the value of an investment. The motivations of individuals are as diverse as the people themselves.

THE REAL QUESTION

So what is active management? Fundamentally, it is simply making adjustments to a portfolio to take advantage of mispriced securities. On the other hand, passive investing makes the assumption that the market is efficient and securities are always fairly priced. Both active management and passive management have pros and cons. So if we can soften our stance and meet
in the middle, we see that both can be appropriate. Some of the oldest market wisdom in the book, “buy low and sell high,” suggests an element of active management. And, while historically most traditional investment firms stuck to the buy-and-hold strategy, many are now coming around to the idea that active strategies also have their place.

When active and passive strategies are mixed they can provide a better overall experience for the investor. We are all familiar with active management strategies and the value they can bring to add performance, respond to changing market conditions, and side-step losses. When combined with more passive strategies, active strategies provide an extra level of diversification, to vary not just asset class, but also holding time-frame.

The real question involves understanding the individual and his or her specific needs, which is where a skilled advisor provides value. Again, the individual is where it all starts. Investment personality questionnaires are helpful, but they are not nearly enough. Many young people today are uncharacteristically risk averse—because their experience is that markets are a very scary ride at best. So an assumption on a questionnaire that because if we are in mid-thirties and have no debt, we should take more risk just doesn’t work. The challenge comes when they have been told they should be invested in the stock market—when an event one-tenth the size of the credit crisis happens—and they frantically push the sell button.

Job as advisors is to help an individual through times like these so they do not miss the upcoming recovery. The idea of having faith that the market will recover and you should hold on, or even invest more, may seem reasonable to a seasoned investor, but it probably will not work for an investor who only knows the last several years of market uncertainty.

It only makes sense to use all the tools at our disposal, including active management. If we can help an individual feel comfortable, even confident, with investing for their future, we are doing a great service for them. Active management is an additional arrow in our quiver to help investors stay invested to achieve their objectives.

THE ANSWER IS

If only the answer could be as simple as, “if an investor needs a 5% return each year over a ten-year period, then pick fund X,” but obviously it’s not. The challenge face the advisors is educating the investors and ourselves, as well as setting appropriate goals and managing expectations - which require a fundamental understanding not only of the markets, but also human behavior.

BEATING THE MARKET: NOT THE GOAL

There are several reasons why “beating the market” is akin to a dog chasing its tail. There are very few people – either investors or managers – that can be as unemotional as Warren Buffet, to the point of licking his chops when a normal person thinks the world is ending. Conversely, Buffet is wise enough to pull in his horns near a top, when everyone else is riding the wave and believing they are geniuses. More to the point, if an investor tells advisors, they want to beat the market and never lose money, they need to be educated, because frankly, they just don’t get it.

As I stated previously, it’s not about beating the market. It’s about keeping investors on track so they can stay the course and reach their financial goals. Clearly, helping investors set realistic goals reduces uncertainty and improves their chance of success.
Each investor is unique and each will almost certainly have unique life circumstances. Keeping them on track to reach long-term financial objectives requires being part savvy investment advisor and part psychologist.

**BEHAVIORAL FINANCE: ITS ROLE**

Most investors need to have a certain amount of money at a certain time, and they can afford to contribute a certain amount towards that goal. Clearly, managing investors to reach their goals requires understanding the individual and how they will react to volatility, uncertainty, or the latest news story. One important piece of the puzzle is developing an understanding of behavioral finance. In short, the discipline can help us understand that people are emotional creatures, prone to delusional bouts that produce over-confidence, fearfulness, confusion, and potentially impulsive mistakes or extreme reticence.

Within the behavioral finance discipline, investor biases have been defined, along with possible solutions to solve for them, to help keep an investor from making costly mistakes. This field is becoming a regular part of the curriculum for investment advisors, and is critical to understanding investors’ needs. Simply put, two basic behaviors that put investors at risk of not meeting their financial objectives are fear and greed.

Behavioral finance is the art of understanding investors’ biases. For wealth management practitioners, creating and delivering effective investment solutions requires a keen awareness of “less than rational” decision making on the part of investors. These behavioral biases are defined as systematic errors in judgment and have been classified in two broad categories in the literature—cognitive and emotional. Cognitive biases are related to faulty reasoning and often better information and educational advice can correct them. Emotional biases, on the other hand, come from impulsive feelings, such as lack of self-control or overconfidence, and are more difficult to correct.

In managing these behavioral biases as well as investors’ aversion to losses, selective memory, or regret, management professionals have two core tools—moderating the investor or adjusting the portfolio. In many cases, a combination of the two approaches may be the most appropriate strategy.

For example, with an investor who doesn’t tolerate risk and has a recent memory of market losses, but who also runs the risk of outliving his or her assets, we can educate the investor to moderate their biases and recommend that they accept some risk in their portfolio to reduce the risk of outliving their assets.

Warren Buffet has made billions in exploiting behavioral finance concepts by “buying when there is blood in the streets.” However, few investors, no matter how risk averse they may believe they are, are comfortable with the downside inherent in investing.

This is where adjusting the portfolio comes in. In many cases, even with good education to help investors curb faulty reasoning, you cannot undo emotional biases. Active management techniques are a key weapon in creating portfolios that can help investors stay invested and reach their objectives despite their inherent biases.
MONEY MANAGEMENT: MORE THAN DIVERSIFICATION OF ASSET CLASSES

Money management, when implemented with discipline, is an excellent tool to get an investor to their investment objectives. As evidenced by the last thirteen years of market behavior, using traditional asset classes—stocks, bonds and cash—just is not enough. So we add commodities, real estate, and other alternative investments. And if you dig deeper, there are additional asset classes that are subsets or combinations of these. All are affected by different economies around the world and the politics that come with them. The point is that there are choices—lots of choices. To narrow those choices investors hire advisors and professional managers to sift through them and choose the best combination at any point in time.

Advisors have the important task of smoothing out the bumps so an investor can live through inevitable market volatility and stay invested. Clearly, diversification is the classic tool to do that. Of course, there are several methods with which we are all familiar—dollar cost averaging, rebalancing, asset allocation, target date investing, position sizing, and laddered portfolios. All of these methods are based on logical rules that take common behavioral biases of investors into account, again, to get investors invested and help them stay invested. Now more than ever, the dynamic global economy demands that we not only decide what to buy, but when to buy it, as well as what to sell and when to sell it. That’s active management. Strategies employed by managers for years with great success are contrarian, growth investing, value investing, momentum, mean reversion, distressed debt and, again, the list goes on and on. Not only do these strategies differ in their approach, but many have varying time horizons that create additional diversification. One core attribute these managers have in common is using processes or rules to remove emotion when making buy and sell decisions. Not every decision will be correct, but management systems that employ a disciplined decision process give advisors critical tools to manage investors—to reduce reactive behaviors and help investors reach their financial goals.

The combination of diversification across asset classes using a mix of investment strategies and diversifying across holding timeframes smoothes volatility and provides a more robust investment portfolio. With markets and economies evolving at such a rapid pace, adding active management to the overall diversification process provides additional comfort for investors’ assets to reach their targets smoothly and efficiently—even in the midst of continual and accelerated change.

CONCLUSION

If we are focusing on the end goal for advisors and their investors, most would agree that to meet the investors’ investment objectives, it benefits both if the investor-advisor relationship is a lifelong one. For the advisor to create that lifelong relationship it is imperative to continue to learn, know the investor, understand their behavioral biases, and based on that knowledge, know what portfolio adjustments to make. A process-driven discipline supports diversification, using a variety of asset classes and holding timeframes.

While the above fundamentals are only a beginning, they provide a framework from which to start. Setting proper goals with investors using a thoughtful planning process, educating them to better understand the biases that affect us all, and navigating the investment landscape using active money management, give investors and advisors a much better chance at financial success.
REFERENCES