“Psychology of Investment”

Pebble Silk Monthly Advisory Communiqué *July ’13*

"When it comes to investing, our choices are generally driven by speculative information we receive from our social interactions with people. People are imperfect processors of information and are frequently subject to bias, error, and perceptual illusions. The general lesson is that psychology permeates the entire financial landscape."

Through this month's newsletter we would like to touch upon a few cognitive biases which seem to hinder our mind's information processing capability.

Bias	Description	Consequences	Mitigation	Question
Anchoring and Adjustment	Individuals remain focused on their original forecasts due to being anchored to a specific value or number.	Even when presented with new information, investors tend to not deviate from their original forecasts.	Give new information a fair analysis (the weight it deserves).	Say you purchased a stock at Rs.25. It then went up to Rs.35, but subsequently dropped to Rs.20. What is your reaction, and your response to this?
Mental Accounting	Financial goals are placed into separate mental accounts along with the wealth that will be used to meet each goal.	Ignores the correlation of assets – if income and capital gains are separated, according to the behavioral lifecycle theory, individuals will spend the income, leading to a reduction in portfolio value.	Look at all investments as if they are part of the same portfolio in order to get a clearer picture of the true portfolio allocation.	Do you feel that each goal should be categorized separately, or do you look at the bigger financial picture?
Framing	Individuals view information differently based on the way it is received (i.e. they may answer a question differently based on the way the question is being asked).	Investors exhibit loss aversion if framed as a potential loss, or risk aversion if framed as a potential gain.	Focus on risk-adjustment returns than on gains and losses.	If you agreed to a plan that was expected to return 9% with an annual standard deviation of +/- 15%, would you be surprised to learn the investment could return -36% in one year, in the worst case? Would you change your game plan based on this information?
Availability Bias	An individual estimates future probabilities by how easily a past event can be recalled – information is categorized using familiar classification – caused by a lack of experience (there are potential categories to place information in that a person is not aware of) or resonance, in which one feels that others will think is a similar way.	People select products based on advertising, because the memories are more easily retrieved and categorized – due to a narrow range of experience an investor might stay in very few asset classes (i.e. avoid international investing)- may over-invest in industries that resonate with them.	Use a strategic long-term approach – develop an investment Policy Statement.	Have you ever made investment selections based on the name recognition or word-of- mouth?

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