

RICHARD THALER & THE GROWING CONTRIBUTION OF BEHAVIORAL FINANCE



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Some Anomalies

- ✓ Why do stock price fluctuate much more than what should be expected from changes in their expected value?
- ✓ Why did the prices for internet stocks rise so high in the late 90s when surveys of professional investors show that most of them believed at the time that the biggest stocks were widely overvalued?
- ✓ Why do we observe return anomalies related to information that, in principle, should have no predictive value?
- ✓ Why do individuals appear to attribute more value to what they already own than what they do not own yet?

Nudging – What and Why

Using positive reinforcements and indirect suggestions to influence the decision process of individuals, while maintaining freewill compliance:

- ✓ Procrastination, lack of planning abilities & knowledge, fear & emotions
- ✓ 40% of individuals in the US spent 5 hours or more planning their next vacation but only 16% spent as much time researching their 401K options
- ✓ The median balance of participants aged 65+ among the plans administrators by Schwab was only \$60,724 as of the end of 2016
- ✓ The average investor left to himself, without guidance, significantly underperforms a simple 60/40 portfolio.

Nudging - How

- ✓ Opting out of plans instead of opting in
- ✓ Higher savings contribution by default with the option to reduce
- ✓ Informing participants how much contribution from his employer he will forego if does not contribute more
- ✓ Auto-escalation of contribution rate with the option to cancel
- ✓ Low-cost life cycle strategy / fund with an option to go bespoke

The Value Premium

The Risk Argument for Value Premium:

- ✓ Fall more at onset of economic recessions and/or
- ✓ Require greater capital to adjust to competitive changes and/or
- ✓ Are more exposed to labor risk ...

The Behavioral Argument for Value Premium:

- ✓ Growth firms are more exciting to own !

Heuristics According to Daniel Kahneman

- ✓ Paying too little attention to prior probabilities
- ✓ Paying too little attention to sample size
- ✓ Illusion of correlation
- ✓ Misconception about predictability
- ✓ Misconception of regression to the mean
- ✓ Inferring the general from the particular
- ✓ Confusing personal preferences with investment risk
- ✓ Hostility to algorithms
- ✓ Illusion of validity
- ✓ Bias against the outside views

Confirmation Bias

“When men wish to construct or support a theory, how they torture facts into their service!”, John MacKay

- ✓ Restricting our attention to a favorite hypothesis
- ✓ According preferential treatment to evidence supporting belief
- ✓ Seeing only what one is looking for
- ✓ Own judgment evaluation

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