The Just Word Podcast

Transcript of Episode 12 – FOMO (fear of missing out) and other emotions

Pat Bolland 00:00
Lisa, great to see you again, you lecture on something called behavioral finance. What exactly is that? And how is it different than behavioral economics?

Lisa Kramer 00:10
I would describe them as closely related siblings or cousins, with behavioral finance being a bit more specific than behavioral economics, focusing on the subset of contexts that pertain to financial markets, financial securities, financial decision-making, but both involve using psychology to help us understand the way people make decisions, focusing on situations where people's behavior in real life differs from what the mathematical models predict. And, so, often people behave in a way that sort of puzzles us with respect to traditional models. And behavioral finance therefore, considers the way human biases emotions, human nature, in general, for example, might affect bubbles in financial markets, or caused people to hold on to poorly-performing stocks longer than they really should. How overconfidence plays a role in people's tendency to actively trade stocks rather than hold them passively. Basically, all the ways in which our human nature causes us to experience worse outcomes in financial settings than we could otherwise achieve if we behaved perfectly like our models say we should,

Pat Bolland 01:36
Okay, but is it quantifiable? And how do you monitor the emotional state of an investor, and then obviously, how it affects their investment decisions?

Lisa Kramer 01:48
So yes, it's quantifiable, we can sort of take a look at how somebody would have behaved if they made their decisions like a robot, which is basically what a lot of the classical economic and financial models predict. And then look at how they actually end up performing as humans. They end up with basically a lower retirement portfolio than they would have achieved if they'd done everything like a robot would have done. And so we can see that the kinds of drivers of decisions like being impulsive, caused people to deviate from their perfectly laid-out financial plans. People act in a hurry, they act in a way that is basically just gut-driven. And these are all warning signs for people acting in a way that we would characterize as as hitting on, fitting under the behavioral finance heading. And so you know, right now, we're seeing markets that are really overheated. And that gets investors revved up. You know, in other times, we've seen markets crashing, and that can cause investors to act impulsively as well. Events in somebody's personal life can lead to emotion-driven decisions. Watching what your peers are doing and trying to emulate their behavior and performance isn't always the best thing for an individual investor. And so these are all the different ways in which emotions can play a role.

Pat Bolland 03:17
You know, it's interesting emotions are obviously, always been in the marketplace. But we've had many, many investment expressions that have been around for a while, like, 'Buy on rumor, sell on

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news'. Is this a different way to approach it? Or is it more data-driven? How are you approaching things generally,

Lisa Kramer 03:41
You know, many of these rumors, like the one you mentioned, they're dangerously close to promoting the idea that investors should try to time the market. In fact, people who try to time the market and jump into a particular security, whether based on rumor, or news, they tend to underperform those investors who just buy and hold. So behavioral finance tells us that humans are subject to all kinds of biases and cognitive tendencies that can lead us astray when making decisions about our portfolios. And so when we try to do something like that, you know, and we act in a way that gets characterized by these kinds of addages, we end up not doing very well or at least not doing as well as we might have. If we had been able to kind of follow that original financial plan that was so carefully laid out.

Pat Bolland 04:38
Yeah. Okay. So then what are the most common misconceptions, I guess you'd say, in the way that people invest? And can you use them to profit? In other words, if you know everybody's panicking, can you buy, so on?

Lisa Kramer 04:51
Oh, nice. There are so many misconceptions in the way people invest in it's hard to even know where to begin. A big one. I'd say that is really topical right now is fear of missing out. So just because somebody else has enjoyed an attractive rate of return on a particular holding, it doesn't mean you should necessarily jump too. But social media, which just surrounds us so much these days, it gives people a platform to brag about their great performance on whatever it is that they've done in a particular holding, while at the same time, they don't necessarily tell us about their investments that haven't done so well. So we see all the great things that they've done and the great performance they've enjoyed. And then we might try to, to emulate that, in hopes that we could enjoy that same good fortune. But that's not necessarily helpful from an investing point of view. Often people end up doing worse than the people that they're trying to emulate. So fear of missing out is is one that I think is really common right now. Overconfidence is another one that is a very common human tendency, especially during market booms like the one we're seeing right now. So active investors, they will often frequently buy and sell. And they pay a lot of fees every time they trade. And they end up basically churning their portfolios, and doing worse on a net basis than people who just had adopted a buy and hold approach. So this is a point where it can be really useful for an investor to compare their portfolio performance to a benchmark. And that can highlight that this kind of quick trading, which is often driven by overconfidence, ends up hurting them a lot. You know, I remember back in the internet boom days, which is dating me, that a lot of people were actually quitting their jobs to become day traders. And, you know, we're seeing something similar right now, where people don't even have to bother quitting their jobs, because they might already be unemployed because of the pandemic. And they basically, they can do no wrong in the choices that they're making, because everything in the market is going up, just about, and they get lulled into the sense that they're fabulous investors. So unfortunately, these things don't tend to last and eventually, they can experience how cruel markets can be. So that concerns me

Pat Bolland 07:28

Justifiable too because if you look at something, a traditional return in the stock market might be 5 to 8% kind of thing. You can make that in one day in Bitcoin. Right?

Lisa Kramer 07:39
It's phenomenal right now. You know, and you mentioned Bitcoin, we see another behavioral phenomenon in what's going on in cryptocurrency markets. So, you know, Bitcoin was worth a lot more a few weeks ago than it is right now. So, you know, it's suffered some pretty big losses, because it's such a volatile investment, you know, it goes up a lot, it goes down a lot. So those folks who bought cryptocurrencies when they were worth a lot more, a few weeks ago, they're looking at their holdings, right now, they're worth a lot less. And they might be dealing with something that we call loss-aversion, where they're reluctant to get out of that security, because they're waiting for it to come back up to that original purchase price. And it's not necessarily the best thing for them to continue to hold that security because it could continue cascading downward. But loss-aversion arises because people tend to feel the pain associated with losses, much more so than they enjoy the pleasure associated with gains. So psychologists have documented this. And it's led actually to Nobel Prize in Economics, the psychologists who documented this, Daniel Kahneman, is well known for showing us all the ways in which these behavioral tendencies can affect us. But loss-aversion is definitely one that we're seeing in crypto markets right now.

Pat Bolland 09:07
Okay, so then I'm thinking how do I make money off the psychology, because if I think of some of the old addages that we were talking about earlier, like 'Sell in May and go away' it's traditionally been said that markets have done well during the summertime because of this psychology. What are your thoughts on that?

Lisa Kramer 09:26
So on the question of making money, I'll say like the best way to apply behavioral finance to make money is in its ability to help us lose money, help us avoid losing money. Pardon me. So, you know, if we just try to strive to avoid making decisions when we're really revved-up emotionally that can actually help us avoid doing poorly. There are some financial products out there, hedge funds, that claim, and mutual funds, that claim to be profiting from behavioral finance. And I would just say that when we do the calculations, they don't actually tend to be outperforming. It's really difficult to apply behavioral finance in a way that helps you outperform markets. But on the question of .sell in May and go away', this sort of captures a seasonal pattern that my co-authors and I have documented that, in a nutshell, people tend to be more risk-adverse during the fall and winter months than they are during the spring and summer months, for reasons related to light exposure. So the fall in winter, are just darker on average than the spring and summer. And we're biological creatures, our circadian rhythm is driven by light. And essentially, the fact that we get less light for half of the year, through our mood is tied with our willingness to hold financial risk. And we've shown this six-ways-to-Sunday in a variety of research papers, including some experiments that we did on on human participants. And you've heard of seasonal affective disorder, most likely

Pat Bolland 11:14
SAD

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Lisa Kramer 11:15
SAD, S A D, it turns out, most people experience some degree of sad in the fall and winter, most of us luckily not to an extreme clinical degree, but just kind of sub clinically for the most part. And that is what is driving these changes in our willingness to hold risk as well, as it turns out. So when people are more blue, they're also more averse to risk. And with financial markets, that means people differ seasonally in their willingness to hold different kinds of securities. And that leads to differences in returns. So stock returns are actually a bit higher, on average, through the fall and winter months. Basically, people demand a higher rate of return during those months when they're more risk averse. And returns on stocks are a bit lower on average during the spring and summer. And so this leads to this this adage, 'sell in May and go away'. Basically, the end result is, you know, people are demanding this higher return for half of the year than they are for the other half of the year. But I just really want to emphasize that this this doesn't mean that people should necessarily try to market-time, because it's not the case that you should be in the market for the fall and winter and then jump out in may go away, you're actually still better-off holding a well diversified portfolio year round, because the rate of return on on risky securities is still on average going to be higher year round than it will be on safe securities, like government bonds.

Pat Bolland 12:54
Yeah. And in fact, if history is any measure, I think the market usually declines when it has a big sell-off ... has the big sell offs in September and October.

Lisa Kramer 13:07
Exactly. And you know, my co authors and I think that this isn't a coincidence, we think that with people becoming more risk-averse in the fall months, they're a little more jittery when it comes to bad economic news. So if bad economic news happens to come out in October, we're just more likely to see a crash than we would be if that same news came out in the spring when our moods are becoming more buoyant. And so that's basically what we think is going on there.

Pat Bolland 13:36
Yeah, it also points to something that I've known for a long time, the markets are not as efficient as they potentially could be. They're not necessarily logical.

Lisa Kramer 13:44
Exactly. And this is just what's at the heart of behavioral finance and behavioral economics. You know, we just see that people are people, they make decisions using their brains, which are prone to all kinds of behavioral biases and cognitive tendencies. And this causes lots of things like bubbles and sudden crashes that we just can't explain using our traditional tools, we need a little bit of human nature to explain those kinds of things.

Pat Bolland 14:13
Okay, so here you're applying your theories to the stock market as a whole, if you will. But there are assets within the stock market, sectors, and could they react differently, and I'm thinking maybe gold or the banking sectors, or we've talked a little bit about cryptocurrencies, but maybe the real estate sector

in the investment world as well as the real estate sector on your street when you're buying and selling houses.

Lisa Kramer 14:41
So in a sense, there's nothing new under the sun, A subset of investors will always find something new to get excited about. So you know, in the year 2000, it was internet stocks and any company that added '.com' to the end of their name would have found this great appreciation in their share price. And, you know, until things came crashing down. These days, it's cryptocurrencies and non-fungible tokens and all kinds of new things. So they're new but there's, you know, a different label slapped on some, you know, novel technology. But more specific to my research on seasonality in human mood and risk aversion. We see evidence of human mood in, you know, just about every facet of markets that we consider. I joke that most of my co-authors have have come along, because they once approached me saying, 'sure you see this in stock markets, but do you think you'd find anything in dot, dot dot'? And then we look and then lo and behold, we do see these behavioral phenomena kind of driving behavior in whatever market it is that that they raised. So you know, we've found evidence of seasonality in mood and risk-aversion, not just in stock markets, but then in government bond markets, in the flow of capital between safe and risky categories of mutual funds. We've got other researchers, it's not just me and my stable of co-authors that have looked into these things, but other researchers have found similar seasonal effects related to human mood in real estate investment trusts in market volatility, in analyst forecasts, and the list just keeps growing. So it's really pervasive.

Pat Bolland 16:34
Does artificial intelligence, or machine learning, offer a workaround to offset behavioral finance issues? Or do you still need a human, a professional money manager to be exact, to interpret sentiment or feeling in the marketplace or other human frailties?

Lisa Kramer 16:55
So computers are ultimately coded by humans, and that makes them vulnerable to the same kinds of biases that affect humans. So for example, #Google's image recognition program, infamously incorporated racial discrimination, and a #LinkedIn computer program incorporated gender bias. So the mere fact that we use artificial intelligence or machine learning to carry out a task, it doesn't magically make it immune to behavioral considerations. When it comes to financial decisions, it can be helpful to introduce some safeguards to help avoid some of the pitfalls of behavioral finance. That could include making a commitment to stick to a well-diversified long-term financial plan, like buy and hold investing, rather than making decisions based on gut instinct, which I'll admit I'm prone to sometimes as well. Whether or not someone should work with a professional money manager depends on the nature of the specific professional money manager that they have in mind, I think. Some of them work for banks that that reward money managers who direct their clients to buy specific high-fee mutual funds. And that's not typically in the best interest of the client. Others might entice their clients to invest in high-risk undertakings like cryptocurrencies, even though such holdings are suitable only for extremely risk-tolerant speculators who are prepared to lose their entire amount invested. So it's important to choose really carefully and I would look for an advisor who emphasizes the importance of diversification, who sells only low-fee products, such as exchange traded funds, and who has a reputation for operating with integrity.

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Pat Bolland 18:45
Okay, so that it does beg the question, though, Lisa, do you actually invest in the stock market or the bond market? Or do you farm that out, because you want to have that non-emotional attachment,

Lisa Kramer 18:58
I do manage my own portfolio. And, you know, that comes with some costs, I am human and so there are times when I deviate from my long-term plan and I'll confess there have been times when that's been costly to me. But I view it as a professional investment, in the sense that I'm a finance professor and it's it's imperative that I really walk-the-talk and understand the kinds of securities that I teach about, and so I just consider it a small cost of doing business, but I'm pretty careful ...

Pat Bolland 19:36
Almost like research for you.

Lisa Kramer 19:37
It's like research Too bad I can't write it off on my taxes. But you know, for the most part I'm a I'm a buy and hold investor who holds a well-diversified portfolio and then a little bit on the side, I'll try experimenting with one or two things, but, you know, I'm ... it never... it's not a great thing when I try to time the market, but I avoid doing that with the vast majority of my investments because I understand the lessons from behavioral finance. And I recognize that it's just better to accept the fair market rate of return on an index portfolio than to try to beat the market. Because ironically, it's the investors who try to beat the market who end up underperforming and yet they keep trying and they keep losing money doing it.

Pat Bolland 20:28
Good for your business, you get to study them. Lisa, thanks so much for your time.

Lisa Kramer 20:35
My pleasure. Nice talking to you Pat

Pat Bolland 20:37
Lisa Kramer, a professor at the Rotman School of Management at U of T ... University of Toronto that is for those not in the know

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