Behavioural Investing

A practitioner's guide to applying behavioural finance

James Montier

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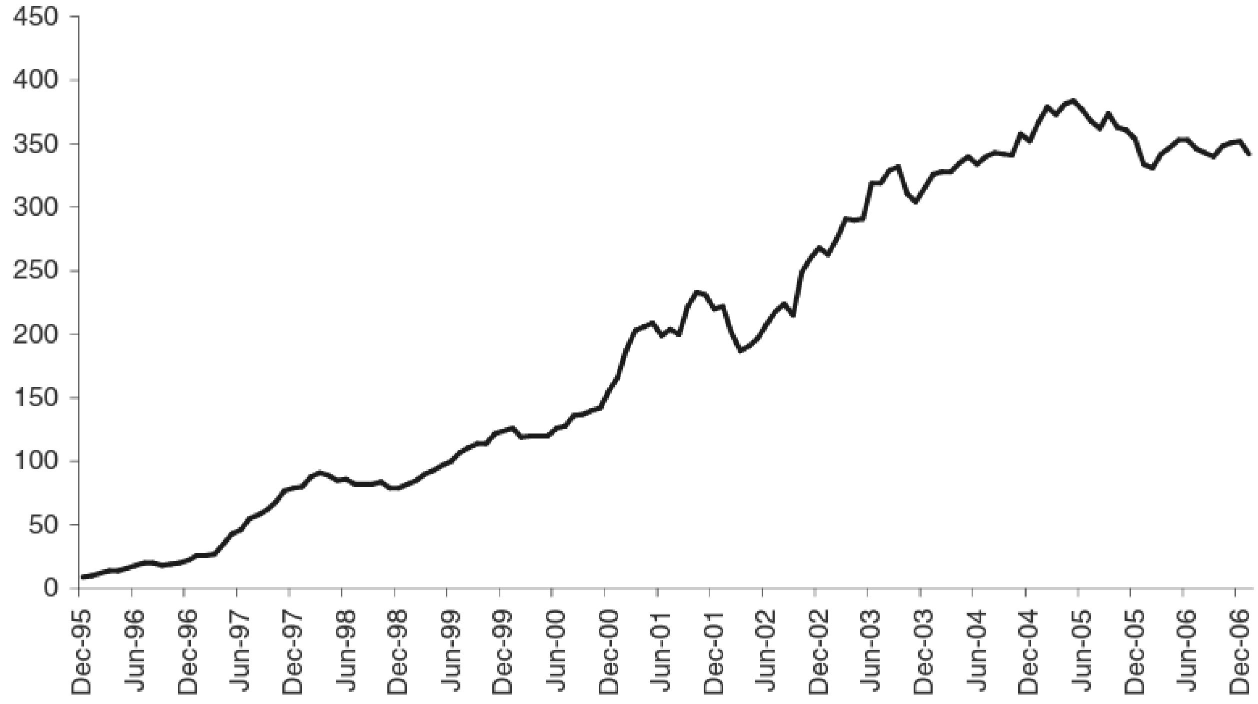
To Connor
The best nephew a proud uncle could hope for

Contents

Preface

This book represents the first six years of an ongoing research project. The aim of this project was to truly understand the psychology of finance and investing and explore its implications for practitioners. There can be little doubt that behavioural finance has never been more popular among professional investors. Certainly, if my diary is any guideline, the subject is still in much demand. The chart below shows the number of times in a rolling 12-month period the words behavioural (or behavioral) finance appear in the press.



I reached the conclusion that I was a natural pessimist while looking at this chart, as the first thing that entered my mind was – it's a bubble. An optimist would presumably conclude that it was a growth industry! I certainly hope the latter interpretation holds true.

My first book on the subject (*Behavioural Finance*, Wiley, 2002) was really the result of a series of lectures I had given to students. This book draws together research written for a professional audience whose time for reading research is highly limited. For this reason each chapter is written to 'stand alone' to allow the reader to dip in and out at will. Each chapter also aims to deal with a practical issue of relevance to the professional investor. However, despite the independent nature of the chapters, I have chosen to group them together into themes, representing the seven major thrusts of my ongoing research project.

I Common Mistakes and Basic Biases

The title here gives the gist. In many ways one of the most powerful insights offered by the literature on judgement and decision making is that we are all prone to the potential pitfalls that psychologists have spent years documenting. Indeed, when I give a lecture to professional investors, those who probably get the most out of the talk are those who identify themselves as the perpetrators of behavioural mistakes. The chapters in this section aim to explore some of the most common biases, and suggest some simple ways in which we might be able to mitigate our susceptibility.

II The Professionals and the Biases

Among some there is a view that the individual investor is the source of all behavioural mispricing. However, I suspect this is far from true. Indeed there are now a number of papers (such as Jackson, Glushkov) that argue convincingly that the professionals may well be the noise traders. The aim of this section is to demonstrate that professional investors are just as likely to suffer behavioural biases as the rest of us. Indeed, in as much as they are experts in their field, they may well be even more overconfident and overoptimistic than lay people.

III The Seven Sins of Fund Management

The aim of this section was to examine a typical large institutional fund management organization and assess its vulnerabilities to psychological critique. The first step on the road to reform is to be able to identify the areas of weakness in the current structure. Issues such as an overreliance on forecasting, the illusion of trading, wasting time meeting company managements, and the dangers of overtrading are covered here.

IV An Investment Process as a Behaviour Defence

If the previous section represented a long list of don'ts, then this section is an attempt to provide a list of dos. It is concerned with investment philosophy/process. Since we cannot control the return on an investment (much as we would like to be able to do), then the best we can do is create a process that makes sense. Here we explore contrarian strategies and value investing as a framework for mitigating behavioural biases. As I am also an empirical sceptic, this section contains many empirical chapters based on demonstrating the principles discussed.

V Bubbles and Behaviour

Of all the areas of behavioural finance none captures the public's imagination like bubbles. This section explores a paradigm for analysing and assessing bubbles and their paths. It is a