equaliFi ACADEMY

CPBM®

CERTIFIED PRIVATE BANKING MANAGER®

Session 5- Economics; Behavioral Finance

Presentation Order

Traditional

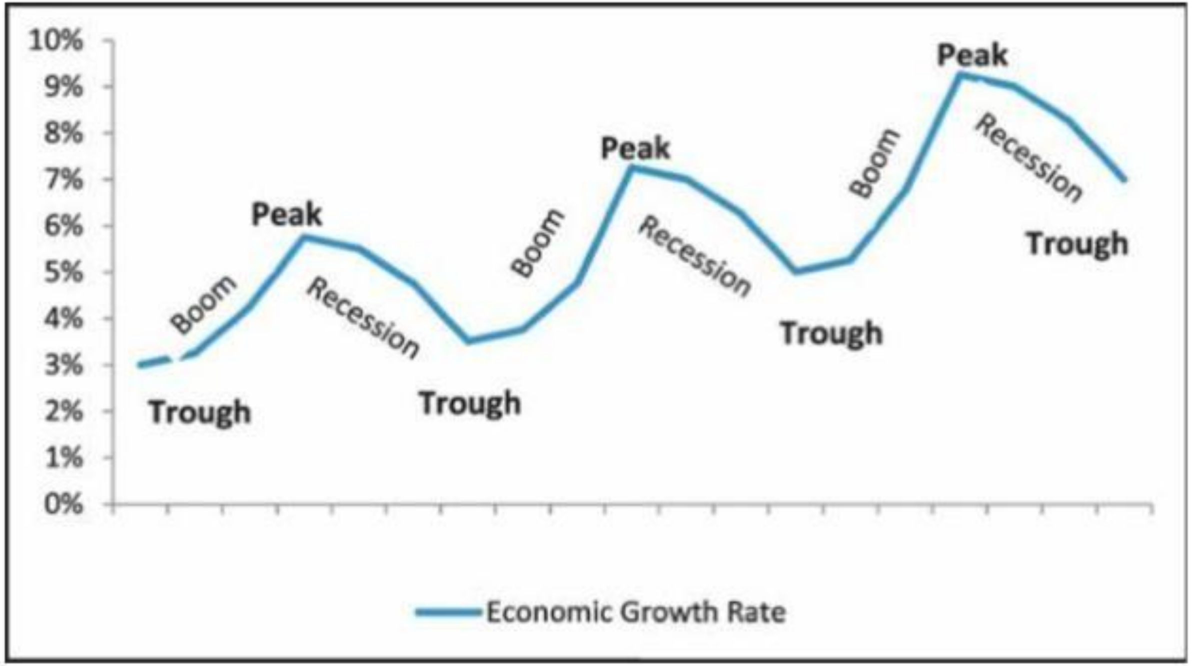
- Economic Cycles and Indicators
- Currency Exchange Rate
- The Deficits

Traditional vs. **Behavioral** Finance

Behavioral Biases

- Overconfidence
- Loss Aversion
- Portfolio Construction and Diversification
- Misuse of information

Economic Cycles



Lag Indicators

provides the information after the event has happened

Eg : GDP and unemployment

Co-incident Indicators

provides the information as the event is happening

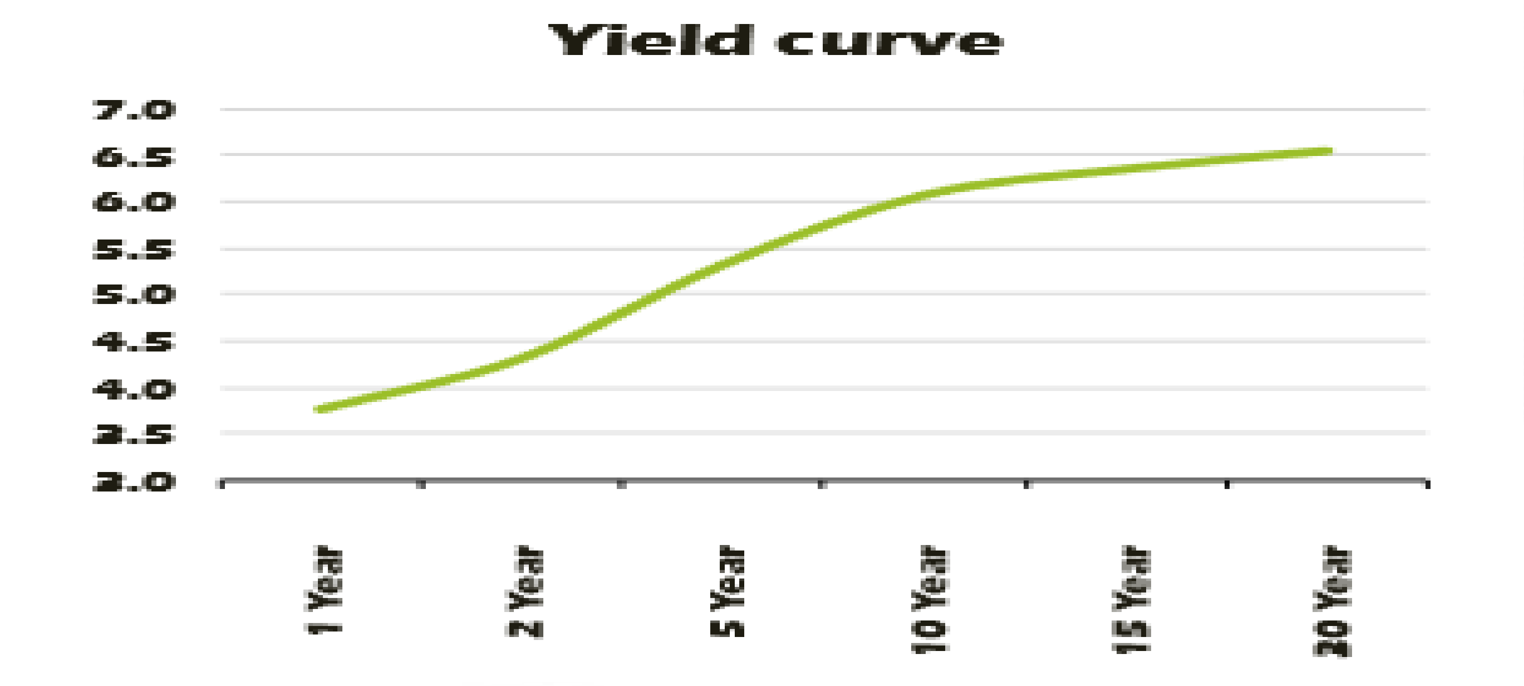
Eg : Personal Income and Consumption

Lead Indicators

provides the information before the event has happened

Eg : PMI, Purchasing Managers' Index or Business Confidece Survey

Interest Rate Views



Currency Exchange Rate

Relative Inflation

- Gap in Inflation between 2 countries
- Countries with higher inflation depreciate in their value

Interest Rate Differential

- Country with higher interest rate has fair chance of currency appreciation

Foreign Currency Inflows

- Higher the inflows stronger the domestic currency

The Debt Ratio

Revenue Deficit

Revenue receipts not adequate to cover revenue expenses

Undesirable

Fiscal Deficit

Extent to which govt. had to rely on borrowing to fund expenditure

Necessary evil

Current Account Deficit

Difference between foreign currency inflows and outflows

We are a current account deficit nation

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The investor’s chief problem
and even his worst enemy
is likely to be himself
Benjamin Graham

Traditional vs. Behavioral

Assumption

- Rational Behavior
- *Firstly*, that when individuals receive new information, they update their beliefs correctly.
- *Secondly*, individuals then make choices that are normatively acceptable.

Reality

- Act Irrationally
- Act in counterproductive systematic manner
- 80% of individual investor and 30% of institutional investor are more inertial than logical

Thankfully I didn't wait to buy!
If I wait any longer, I will not profit from the trend. BUY
Ah, I see a trend. I should watch this market.
I will use this correction to increase my position. BUY
Wow! At this price I will double my position. BUY
I can't believe it! The price has now halved. This must be the absolute bottom!
Why doesn't the banking associatiion have anything to say about this?
Enough is enough! I should sell and never look at stocks again! SELL
Luckily I sold everything!
Ah, it will still fall...
What did I say?
What is going on here?
I knew all along that it would recover.
Whatever, I will buy again! Anyway, it is cheaper than last time. BUY

Overconfidence

Overconfidence Bias	• At its most extreme investor is susceptible to Investment Fraud
Self-Attribution Bias	• Attributing successful outcomes to their own actions • Should track personal mistakes
Active Trading	• Excessive traders always underperform • The Courage of Misguided Convictions, 1999. 20% Least Active Traders 18.5% & 20% Most active 11.4%

Loss Aversion

Disposition Effect

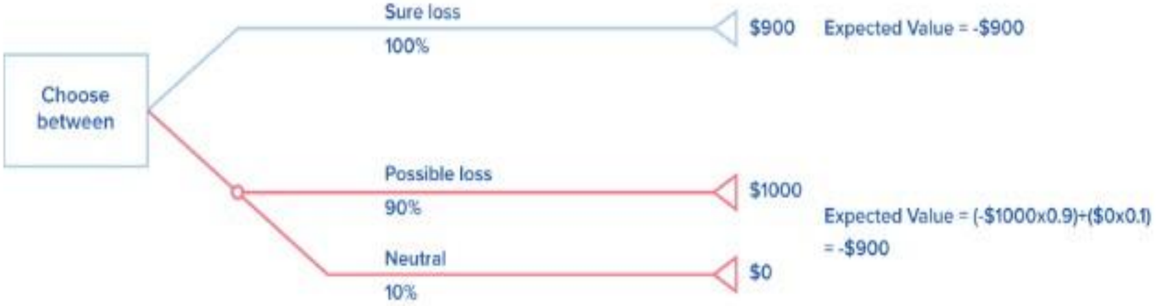
- Tendency to sell winning positions and hold on to loosing ones
- Solution : “Cut your losses short and let your winners run.”

Fear of Loss

- Next Slide has details

Figure 2: Loss Aversion: How Users Make Decisions

Note: When dealing with gains, people are risk averse and will choose the sure gain (denoted by the red line) over a riskier prospect, even though with the risk there is a possibility of gaining a larger reward. Note also that the overall expected value (or outcome) of each choice is equal.



Note: Losses are treated in the opposite manner as gains. When aiming to avoid a loss, people become risk seeking and take the gamble over a sure loss in the hope of paying nothing. Again, both options have equal expected values.

Portfolio Construction and Diversification

Framing

- Nobel Prize winner economist Harry Markowitz - an investment should not be evaluated alone, but rather by how it affects the portfolio as a whole.
- “Narrow” & “Wide” frames

Mental Accounting

- Having different buckets of Expenses
- “Windfall” gains are not treated with same caution

Familiarity Bias

- Familiarity gives false sense of confidence
- “Equity home bias”, Employer’s stock etc.

Misuse of Information

Anchoring	• First source of information • Eg : Initial purchase price of a stock
Representativeness Bias	• Also known as recency bias • If strong earnings for a co. are announced then assuming that next qtr would also be good
Gambler's Fallacy	• Seeing patterns where none exist
Attention Bias	• Tendency to buy rather than sell those stocks that catch their attention


JUST A NORMAL DAY AT THE NATION'S MOST IMPORTANT FINANCIAL INSTITUTION...
I'VE GOT A STOCK HERE THAT COULD REALLY EXCEL
REALLY EXCEL?
EXCEL?
SELL?
SELL?
SELL
SE
SELL!
SELL!
SELL!
SELL!
ELL!
SELL!
THIS IS MADNESS! I CAN'T TAKE ANYMORE
GOOD BYE?
GOOD BYE!
Bye?
Buy?
Buy!
Buy!
BUY!!
Buy!
Bu
Buy!
I'VE GOT A STOCK HERE-

Thank You