The international financial markets are in constant motion. Forecasting price movements is difficult – not least because people only too often behave irrationally. The behavioural finance approach provides new insights into investor behaviour. Professor Thorsten Hens, Director of the Institute for Swiss Banking, is one of the most prominent advocates of this young scientific discipline.

By Heike Isselhorst

Theme: Forecasting investor behaviour

The human factor

For a long time, the ideal of Homo oeconomicus dominated the various models aiming to elucidate the science of economics. The utility maximizer, who always makes the rationally correct decision even in complex systems, should also be able to reliably predict the development of prices on the stock exchange. But with every crisis in the financial markets, it became more clear that even financial investors are only human – and often make completely irrational decisions. Newer approaches, such as behavioural finance, therefore put more emphasis on this human factor. They apply the findings of the behavioural sciences to the field of investment decisions in order to better anticipate the future behaviour of market participants – even if it is irrational. Professor Thorsten Hens sees this as an important step forward: "Only those who can assess how other investors will behave in the future, will have long-term success in the stock market."

Evolutionary lack

The reason why many investors in financial markets often behave irrationally can be found in nature. Many human behaviours have been forged in an evolutionary process over many millions of years. For this reason, seen from a human point of view, they are completely correct and rational. "If a panic breaks out somewhere and everybody starts to run, it is a perfectly reasonable decision to run with the herd," explains Professor Hens. "But if we apply this innate behavior to an artificial situation such as the financial markets, things can only go wrong." Mankind is not geared for this complex system – and given the fact that the financial world in its present form is a very recent phenomenon, it will take a long time until the rationally correct modes of behaviour have been bred into our flesh and blood.

Particular market environment

Our innate, instinctive behaviour will fail because the financial markets are not a natural system, and as a consequence they obey different rules. "The difference is mainly in the so-called feedback effect," says Professor Hens. "On the stock market, prices respond to the behaviour of investors. They are the result of a collective decision." In this way the stock markets differ significantly from nature. Professor Hens illustrates his point with an example: "The weather does not care what we humans think of it. If the forecast calls for a beautiful, sunny day, and everybody dresses in anticipation of the warm temperatures predicted, it can still rain." But conversely, if the stock market outlook is bad, many investors will sell their positions. As a consequence, the indices actually do decline. The prophecy fulfills itself, and when even more investors sell their holdings, the share price falls and falls, and a downward trend is created.

Tricking nature

Many investors do in fact want to make rational decisions when it comes to their investment portfolio. But if the market enters a period of turmoil, it is difficult for them to remain calmly above the fray. As a rule, knee-jerk reactions are mostly irrational and should therefore be avoided at all costs. But what can you do to guard against the instinctive herd mentality? As an effective means to outwit one's own nature, Thorsten Hens recommends to keep a diary to record all investment decisions. "In this investment diary, the investor should write down all the reasons that originally spoke for the purchase of the particular security. Only if these reasons become invalid should he sell his shares – and not because ups and downs in the market are making him nervous." Even when things are going well for the investments, Professor Hens says the decisive factor should not be how much profit a security has already generated: "What matters is what continues to argue for holding the investment."

Information: get the dosage right

To remain as unperturbed by events in the financial markets as possible, it is best to absorb information and stock market news only in the smallest doses. Professor Hens also knows about the problem of information overload: "Investors with a long-term investment horizon of perhaps seven or ten years should monitor how their investments are doing at most only once a year, and not follow the stock ticker every day." And keeping quiet about your investments is also good advice, because when friends or colleagues know about your holdings, this increases the pressure immensely to demonstrate success in their eyes – the result being that profits may then be realized too early. According to Professor Hens, investors should make themselves immune to environmental influences. "If you want to have long-term success in the financial markets, you need to be willing to be the odd man out. You have to tolerate swimming against the tide for quite a while and, in the worst case, you even need to be willing to face ridicule."

Tantalizing world

International financial markets are very complex, and are not always easy even for regulatory authorities and experts to grasp. So how is it that so many private investors dare to invest their capital in the stock markets? "The stock markets create the illusion that you can become rich without work. Just punch a few keys on your smartphone, and hey presto! You will be rolling in profits. Unfortunately, there is no such thing as this land of milk and honey," warns Professor Hens. "Especially small investors can often be sucked into the markets' riptide. Then they continue speculating in the hope that the big win will come with the next transaction. The hype is just too good not to be true." Even if there are no universally valid strategies for market success, Thorsten Hens does have one piece of advice to offer: "Private investors should not underestimate the financial markets. What looks like easy money requires, in reality, a lot of experience and also the willingness, once in a while, to learn the hard way." But even people who are not professionals can take a chance on the markets. "Anyone who reflects on his own behaviour is already one step ahead," he says. "And when it comes to the operational implementation, you can always rely on professional support." ■

Professor Thorsten Hens has been the Director of the Swiss Banking Institute of the University of Zurich since 2007. In addition to his professorship for Financial Economics at the University of Zurich, the native German also teaches as an Adjunct Professor at the Norwegian School of Economics and Business Administration in Bergen, Norway. Professor Hens is among the most important experts in the research areas of Evolutionary Finance and Behavioural Finance.

Photo: Gian-Marco Castelberg, 13photo