STRATEGIC GLOBAL ADVISORS, LLC

Conference Notes: "Decision Theory 20 Years Later: How Has it Changed?"
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Are we any better now than we were 20-years ago at understanding how we make investment decisions? That was the question this half-day conference on decision theory and behavioral finance tried to answer. It was held to mark the 20-year anniversary of a similar conference in 1991 when behavioral finance was in its infancy. Two of the speakers (Werner DeBondt and Hersh Shefrin) were speakers at the original conference and a number of attendees had also attended the original conference 20 years earlier.

Paul Schoemaker (Founder & Chairman of Decision Strategies International) spoke on the topic of "Behavioral Decision Theory: Past, Present, & Future". He first described the evolution of decision theory from decision trees, utility theory and probability analysis in the 1960s to the heuristics and biases, framing of questions and effects of emotions surrounding behavioral finance in the 1990s. Schoemaker pointed out that neuroscience has provided further insights into how the brain works and how decisions are made.

Paul talked about how investing is still an exercise in decision making under uncertainty even when sophisticated quantitative tools such as optimization, linear programming or Monte Carlo simulation are used. He said these tools can sometimes create the illusion of safety. We agree with that at SGA and have built an investment process that includes our own sophisticated tools but relies heavily on the judgment of our investment professionals when it comes to adding or removing a stock from one of our client portfolios.

"Asset Price Bubbles" was the title of a talk given next by Werner DeBondt (Professor & Director of Center for Behavioral Finance, DePaul University). He discussed various recent market bubbles and potential causes, human behaviors among them. Werner specifically covered several studies of momentum and human psychological effects in markets around the world. He mentioned a very interesting quote from a Paul Slovic article from a 1972 edition of the Journal of Finance: "A full understanding of human limitations will ultimately benefit the decision-maker more than will naïve faith in the infallibility of his intellect." This is highly relevant at SGA since we know we need an objective measure of the attractiveness of thousands of available non-US equities in order to narrow our focus before conducting traditional analysis.

Hersh Shefrin (Professor of Finance at Santa Clara University) discussed: "Psychology and Regulation: A 20-Year Update". Hersh is well know in the behavioral finance field and peppered his talk with numerous behavioral finance insights while focusing primarily on how the strength of financial market regulation tends to be determined by financial bubbles and recessions and reactions to these rather than forward-looking analysis.

Michael Falk, CFA (Founder of Michael S. Falk Asset Consulting) spoke on the topic of "Psychology, Neurology… How Your Biology Impacts Your Investment Decisions". He believes as humans we "satisfice" in lieu of optimize, in other words figure out what's good enough. Our brains economize our scarce metabolic resources since they use a lot of energy. So "good enough" prevails and our brain quickly adapts to our present environment, creating biases among investors. He also discussed emotions and how they affect risk taking. His talk made me think of how an investor with a longer term time horizon (like the ones we have at SGA) may be able to take advantage of short-term inefficiencies in the market caused by human behavior biases.