

## Behavioral Finance Theme

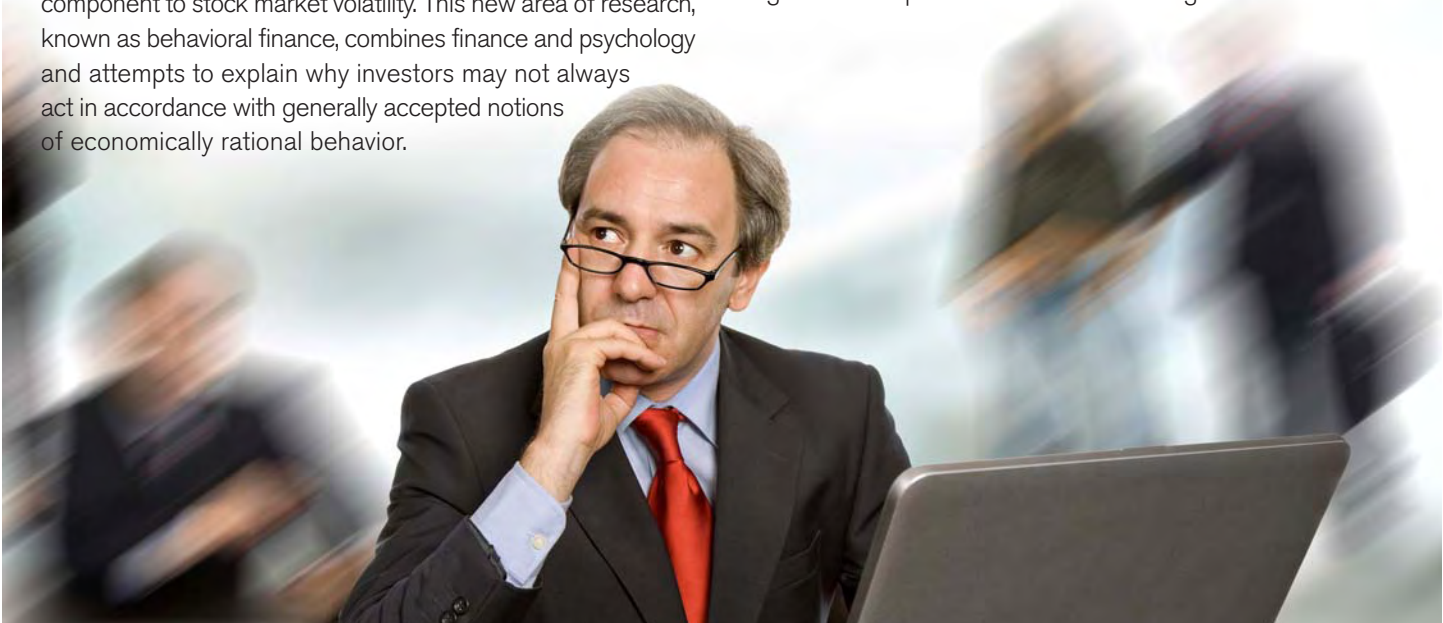
### *Can human emotion really move the stock market?*

One can argue that over the last one and a half years, stock market swings have been magnified by investor emotions. But can human emotion really move the stock market? If so, what implications does this have for modern financial theories about how markets function? In this section, we will explore this highly topical theme and discuss how the recent turbulent period calls into question some long-held beliefs about how markets operate.

One of the cornerstones of modern financial theory is the Efficient Market Hypothesis, which states that financial markets (i.e., stock prices) incorporate all available information about a given stock and accurately reflect that stock's true underlying value. Strict adherents to this theory believe it is impossible to "beat the market", since it would be impossible (in theory) to buy stocks at discounted prices or sell at inflated prices. This theory builds on one of the main tenets of neoclassical economics, which states that individuals, with a given set of constraints and preferences, will make economically rational decisions. The last 30 years of stock market history, replete with volatile cycles of booms and busts, bubbles and crashes, have contradicted these theories by proving that stock prices can (and often do) deviate from their fair value, and do not always reflect economic fundamentals. As a result, new financial theories have been developed, aimed at understanding the human (emotional) component to stock market volatility. This new area of research, known as behavioral finance, combines finance and psychology and attempts to explain why investors may not always act in accordance with generally accepted notions of economically rational behavior.

While this type of "irrational" behavior typically occurs in short term intervals, the consequences can be long-lived and severe. From May of 2008 through March of 2009, the investment decision-making process for many investors was based largely on fear and pessimism, which caused some to sell out at exactly the wrong time – at or near the bottom. Conversely, in the most recent quarter, euphoria has taken over as the driving force in a market characterized by a slightly improved economic landscape, but lacking fundamental indicators pointing to a sustainable recovery.

Since this rapid change in sentiment is nearly impossible to predict, the best course of action to take is to adhere to a predefined buy and sell discipline, and use the volatility to your advantage. Having predefined entry and sell price targets on stocks takes much of the emotion out of the investment decision process. This enables investors to base their investment decisions on objective fundamental data rather than on subjective, sentiment driven commentary in the financial media. Throughout the past eighteen months, we have worked hard to stick to our discipline, buying stocks in the face of massive selling pressure and selling stocks on days when the market was up significantly. While this means we may underperform (relative to the market) for short periods of time, sticking to a predefined discipline (i.e., taking the emotion out of the investment process) will deliver significant outperformance over the long term. ■



**Developing Themes:** 1) Are we creating another bubble by setting low worldwide interest rates? Will the 800 pound panda in the room (China) be the cause? 2) Will inflation be caused by the current monetary and fiscal policies? How will inflation be possible if there is not private credit expansion?