

An Introduction to Common Behavioral Biases Affecting Financial Decision Making

Darren Agombar - Claradan Futures Ltd

11th June 2008

Disclaimer: Futures and options trading are speculative and involve risk of loss. The information in this seminar is taken from sources believed to be reliable. It is intended for information and education only and is not guaranteed by the CME Group as to accuracy, completeness, nor any trading result. It is not intended as investment advice, nor does CME Group endorse or support any product or service represented in the presentation. The views and opinions offered by individuals or their associated firms in interactive seminars are solely those of the authors, and do not necessarily represent the views of the CME Group. The Rules & Regulations of the CME and CBOT remain the authoritative source on all current contract specifications & regulations.

Derek Sammann

Managing Director, Head of FX Products

Introduction and Background

Introduction

- This is the first in a series of 3 presentations that is designed to be an introduction to Behavioural Finance.
- This presentation will look at a selection of behavioural biases and how they can affect financial decision making
- Discuss how the impact of these biases can be countered
- It will also discuss the indirect benefits knowledge of decision making processes can have for individuals

Introduction and Background

Background

- Trader for 20 years on behalf of banks and for past 5 years independently.
- Career has been spent in London, Dubai and Tokyo.
- Predominantly in currencies and emerging markets.
- Left banking sector to trade independently to have access to wider range of products and develop behavioural approach.
- Research is conducted in collaboration with University Business School in the UK.

Why Psychology and Decision Making?

My Own Experiences

- Change in environment from Banking to Independent trader triggered need for solutions due to performance downturn.
- Mainstream Behavioural Finance and ‘trading psychology’ didn’t provide the solutions I required.
- Prompted research and application of *academic* psychology and decision making.
- Resulted in major improvements in individual performance and overall market appraisal.

Claradan's Approach

REA – Recognition – Education – Application

- **Recognition** of the behavioural influences that drive collective and individual investor actions through ongoing analysis
- **Education** of the theories and concepts affecting behaviour and market action constantly updated through academic partnerships and research
- **Application** of acquired knowledge to financial markets will enable fresh insight and individual performance enhancement.

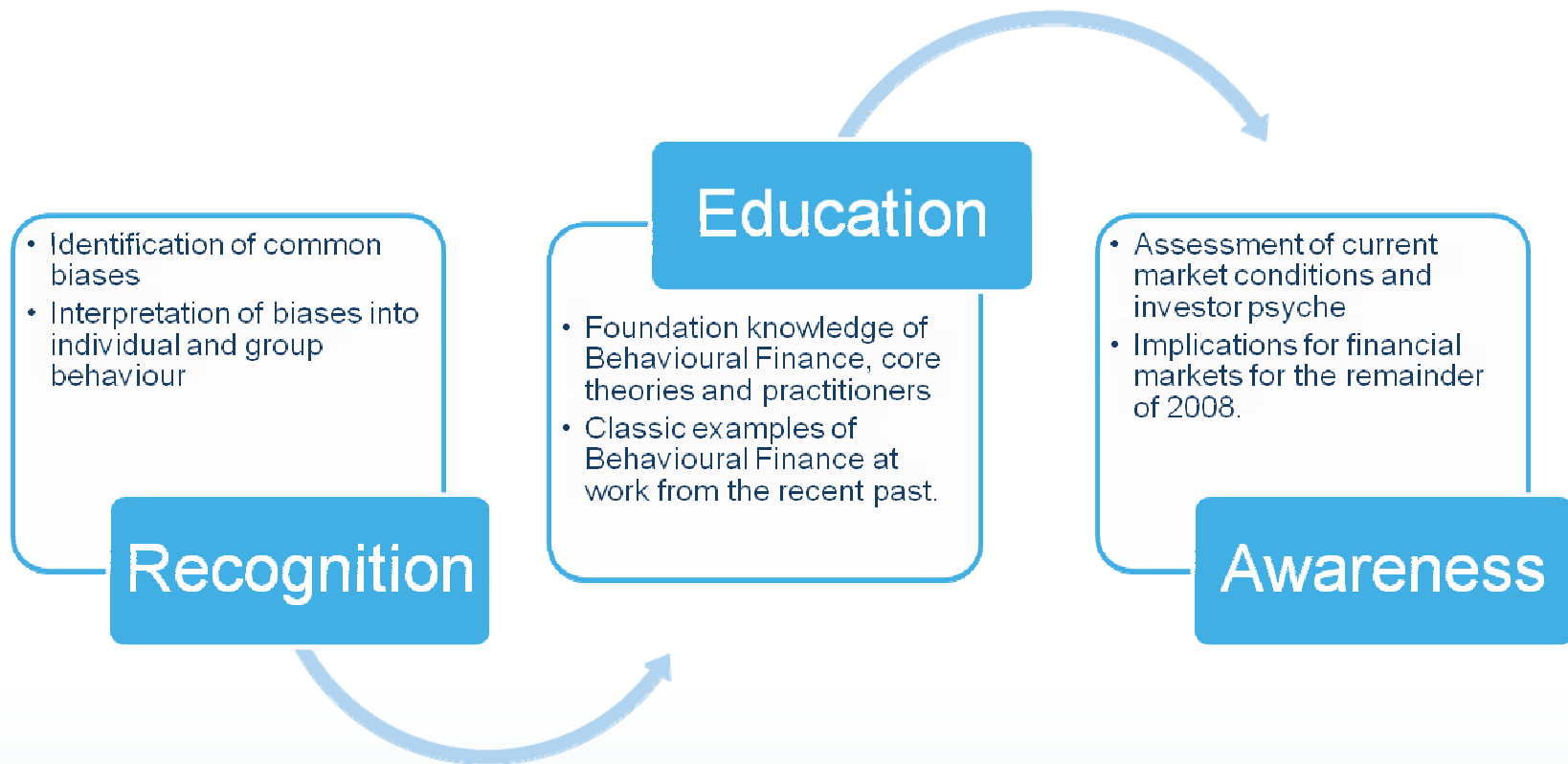
Claradan's Approach

Trading Strategy

- Resultant trading strategy incorporates Psychology and decision making.
- Develops individual performance through the understanding and recognition of behavioural biases.
- Enhances market appraisal and trade recognition through identifying collective behavioural biases.

REA

Recognition, Education and Application



Behavioural Biases

Behavioural Biases

- Reinforced Habits
- Cognitive dissonance
- Conjunction theory

Behavioural Biases

Reinforced Habits – Key Points

- A basic tenet of Psychology
- Draws from the branch of Psychology called behavioralism and Learning Theory.
- Deals with conditioning and how experiences shape our behaviour.
- A learned behaviour

Behavioural Biases

Example of Reinforced Habits Affect

Long/Short Bias

- When traders express a preference to either a long or short position
- Bias usually develops from a profitable event or period
- It becomes a reinforced habit and begins to influence decision making

Behavioural Biases

Example of Reinforced Habits Affect

Break out – Fade trader

- Bias shows in a more general defining trading approach
- Traders often define themselves as a fade/break out/contrarian trader
- Often caused by a significant event or large profit

Behavioural Biases

Cognitive Dissonance - Key points

- From the study of social psychology
- Theory pioneered by Leon Festinger 1957
- When two conflicting opinions are held by an individual simultaneously causing an internal conflict

Behavioural Biases

Example of Cognitive Dissonance Affect

- Present and active at the change in market trend
- Causes some investors to hold positions long after fundamentals have changed
- Key identifying trait – feeling of uneasiness psychologists term ‘inner conflict’

Behavioural Biases

Example of Cognitive Dissonance Affect

- Pursuing a strategy that no longer works
- When underlying market conditions change
- Traders can blame the market for lack of success but fail to alter their behaviour – often viewing any change as a weakness

Behavioural Biases

Conjunction Fallacy - Key Points

- Drawn from the study of decision making
- Under the umbrella of representativeness
- Amos Tversky and Daniel Kahneman
- When an outcome is considered more probable the more complex it is.

Behavioural Biases

Example of Conjunction Fallacy Affect - *Market Analysis*

- Can occur when original assessment/analysis fails to materialise
- Temptation to offer a more complicated scenario that will allow original prediction to stay 'in play'.
- The more complex the scenario becomes, the bias tempts us into increasing its probability.
- Increasing the amount of predicted, connected events decreases the probability of the likely outcome.

Behavioural Biases

Example of Conjunction Fallacy Affect - Technical Analysis

- High level of available patterns encourages complex predictions
- Leads to a breakdown in the weightings to likely probable outcomes
- A rich breeding ground for Conjunction based biases
- Retrospective justification through identifying past supporting patterns.

Methods of Countering Behavioural Biases

Countering Behavioural Influences

- Trading environment allows for instant decision feedback
- Longer term decision results benefit from journal keeping, allowing accurate reflection of thoughts and conditions at the point of decision making.
- Systematic approach such as REA helps to monitor behavioural Influences
- Learn the language of psychology and decision making !

Psychology & Decision Making

– A New Language

- Use the model of sitting in a cafe in France or Venice listening to the ‘hub-hub’ around you – you enjoy the atmosphere but don’t really understand what’s going on.
- Once you learn a few lines you can listen to the conversations and enjoy the atmospheres and appreciate it a little more
- The more you learn the more you can enjoy the country etc
- Once you have learnt these phrases you can’t avoid but understand the background conversations
- This is my experience with psychology and decision making in finance – once you become aware of the biases affecting your actions you can’t switch it off and you begin to become conscious of those things that in the past operated in yr subconscious.
- This comes from educating yourself about the heuristics etc that u are susceptible to

Bi-product of learning about psychology.

Potential Reduction in Stress

- Potential benefit from understand decisional processes can be a reduction in individual stress.
- Helps in separating emotion from decision making
- Allows decisions to be considered in abstract form, allowing the individual to separate the process from the outcome
- Result can be that the individual experiences less stress from incorrect decisions allowing a clearer appraisal and assessment going forward.

Summary

- Knowledge of Psychology and Decision Making processes a valuable addition to any trading strategy
- Can enhance and develop individual performance through the control of biases
- Can increase the accuracy of general market appraisal and trade identification through understanding of collective behavioural influences
- Can contribute to a reduction in individual stress by promoting a separation of emotion from the point of decision making.

What Next?

- The next presentation in the series of three will look at the history of behavioural finance.
- The cornerstone theories and practitioners.
- The evolution into today's multi discipline field
- This will make up the **Education** segment of our REA approach.
- More information can be found at www.claradan.co.uk

Stay Up to Date with CME Group

EVENTS & UPDATES

Receive regular updates on upcoming events offered by CME Group by visiting our Subscription Center where you can opt-in for our Events & Updates e-mail. www.cmegroup.com/subscribe

TRADING KNOWLEDGE CENTER

Visit the CME Group Knowledge Center where you will find the latest educational offerings on futures and options, including all major asset classes. www.cmegroup.com/edu

- **Upcoming Events Calendar**
- **Archived Online Seminars**
- **Interactive Tutorials**
- **Quotes and Charts**
- **Find-a-Broker tool**
- **Trading Simulators**

For more information, contact us:

edu@cmegroup.com 312.930.6937

info@cmegroup.com 800.331.3332