

# The Application of Behavioral Finance to Current markets

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# Introduction

## Recap

- Series has introduced a sample of behavioural biases and identified their potential affect on financial decision making
- Introduced Claradan's systematic approach – REA - to applying psychology and decision making to financial markets
- Highlighted the advantages of incorporating a behavioural approach to any trading strategy
- Knowledge of decision making processes can enhance individual performance and improve market analysis
- Suggested potential indirect benefits of knowledge of decision making processes can give – such as reduction in stress

# Introduction

## Background

- Trader for 20 years on behalf of banks and for past 5 years independently.
- Career has been spent in London, Dubai and Tokyo.
- Left banking sector to trade greater variety of products and to pursue a behavioural trading strategy
- Ongoing research in psychology and decision making supports trading and analysis
- Active trader, still trade every day.

# Introduction

## Why Behavioural Finance

- Behavioural Finance is an established and respected field of study
- The affect of behavioural biases on financial decision making are clear to see and can often cause powerful market moves
- Behavioural biases can inhibit individual performance and cloud rational market assessment
- Gaining knowledge of decision making processes can give the double edged advantage of individual performance enhancement and increasing opportunities through the recognition of collective behaviour

# Introduction

## Behavioural Assessment of Market Conditions

- A behavioural assessment of current market conditions
- The elements that identify this
- Examples of the power and effect behavioural influences can have
- How did the market reach this particular position?
- Dangers for investor sentiment going forward
- Demonstration of real time application through suggested trade idea

# Behavioural Assessment of Market Conditions

## Current Market Conditions

- Markets are subject to a high degree of powerful behavioural influences
- Effects seen in individual assets as well as broad market sentiment
- Violent volatility and extreme price ranges have become common place
- Breakdown of normally reliable strategies and models compromising returns

# Behavioural Assessment of Market Conditions

## Current Market Conditions – Investors Perspective

- Traders find the changeable conditions difficult often pointing to feeling that they have to 'reinvent' themselves and/or strategy
- Volatility narrows focus and increases reactivity to news, headlines and rumours
- Reluctance to hold positions causes reduced liquidity and adds to volatility
- Fear factor

# Behavioural Assessment of Market Conditions

## Behavioural Influence Indicators

Presence Of:

- High level of weak, fundamentally flawed correlations
- Highly reactive nature of markets to headlines, news and rumours
- High levels of volatility seen across a wide selection of asset classes
- Sudden changes in market direction and sentiment increase in frequency

# Behavioural Assessment of Market Conditions

## Behavioural Biases Active in Current Markets

- Cognitive Dissonance
- Contagion
- Conjunction
- Assimilation
- Herd Behaviour

# Behavioural Assessment of Market Conditions

## Example of Behavioural Influence -

### Psychological Price Levels

- Unique opportunity to study investor behaviour as several markets approached round number thresholds
- Gold \$1000, Oil \$100 and \$/Yen 100.00
- Rational thinking contravened as biases kicked in
- Resulted in increased volatility as 'importance' accredited to these levels

# Behavioural Assessment of Market Conditions

## Example of Behavioural Influence

### Market Timing

- Identifying anomalies when communal market opinion fall behind, and fail to acknowledge change in fundamentals (*Dissonance*)
- Recognising these breakdowns in rational thinking can provide opportunities for fast reversals
- Identifies states of '*over pessimism*' or '*over optimism*'
- Our analysis identified this in late March '08 – *S&P500 approximately 1310* and again in mid May '08 – *S&P500 approximately 1410*

# Behavioural Assessment of Market Conditions

## How Did The Market Reach This State

- The roots of current market conditions lie in the events beginning in Summer '07.
- The significant shocks of H2 2007 such as the confirmation of the credit crisis, the first bank write downs and Sovereign wealth cash injections, the demise of Northern Rock in the UK.
- These events 'conditioned' investors and 'primed' behavioural biases
- When events re emerged in H1 '08 – behaviour was re-instigated and volatility and violent price action ensued

# Behavioural Assessment of Market Conditions

## Behavioural Biases That Shaped Market Conditions

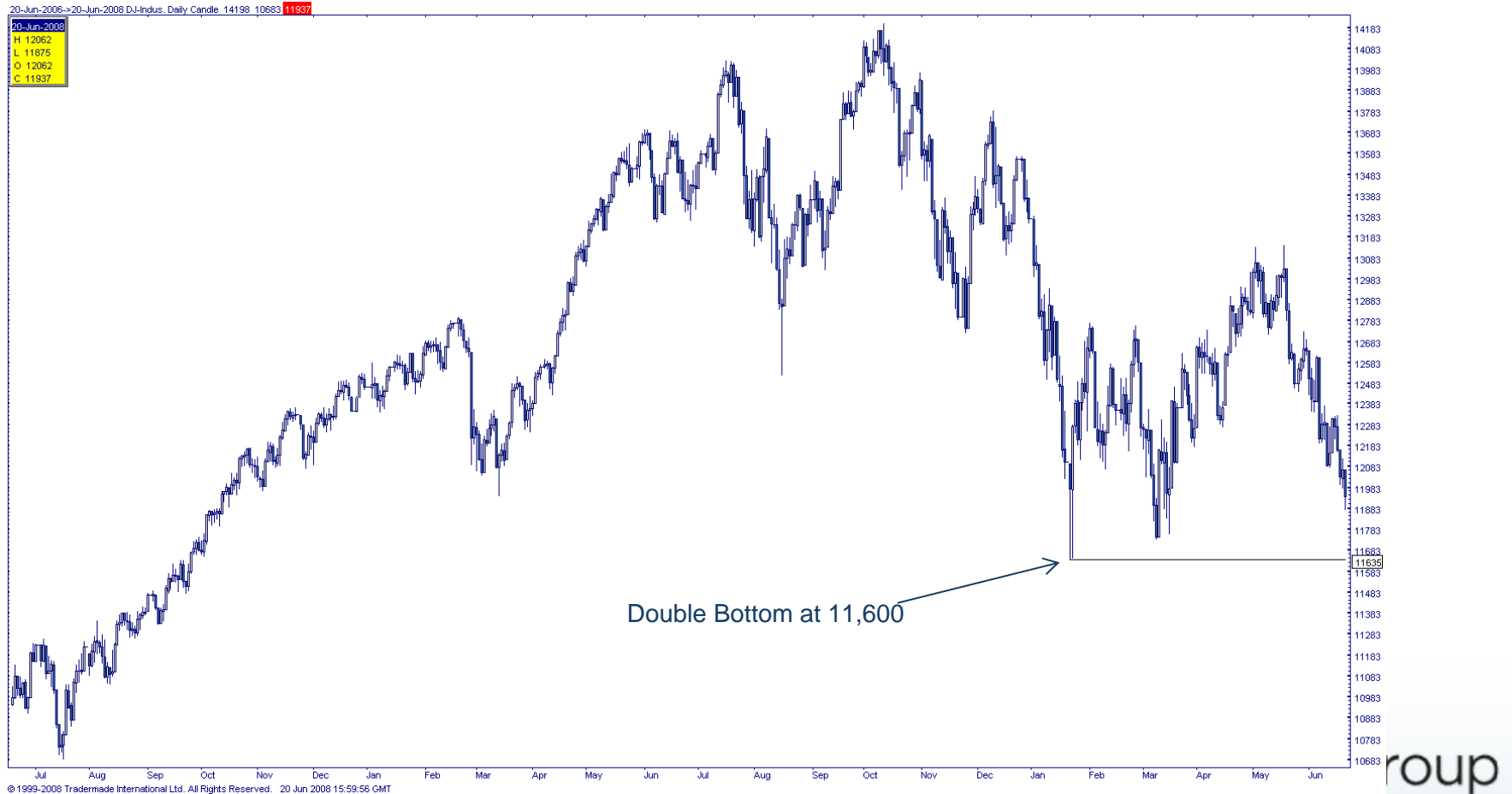
- Representativeness
- Availability Bias
- Herd Behaviour
- Reinforced Habits

# Behavioural Assessment of Market Conditions

## Potential Risk to Equity Markets

- Aggressive Fed rate cuts coincided with SocGen 'rogue trader' position liquidation and the bottom of equity sell off.
- Created a 'line in the sand' in the DJI at 11,600
- Emotions of the moment, fear and panic, closely associated with this level.

# Behavioural Assessment of Market Conditions



# Behavioural Assessment of Market Conditions

## Potential Risk to Equity Markets

- Associated emotions, fear and panic, could be reactivated if level tested or broken
- Placing investors at the heart of the crisis again
- Potentially causing contagion selling of global equities as investors are back in the moment of the peak of the crisis

# Behavioural Assessment of Market Conditions

## Risks Behavioural Influences Pose for Markets

- High level of volatility causes challenges for previously successful strategies
- Liquidity can not be relied upon, markets experience pockets of erratic price action
- Difficult for investors to maintain rational assessment as 'noise' reaches crescendo

# Behavioural Assessment of Market Conditions

## Summary

- Current market conditions demonstrate strong evidence of behavioral biases influencing sentiment and prices
- These can cause powerful and destructive volatility, eroding confidence and liquidity
- Biases to remain primed and part of investor psyche for foreseeable future
- Prices and levels can become tied to emotional experiences and trauma of the moment, and can be reactivated if levels surpassed or breached

# Behavioural Assessment of Market Conditions

## Closing

- Today's Presentation completes our REA approach.
- The series has demonstrated behavioural biases and the influences they can have
- Built foundation knowledge of the history and theories of behavioural finance providing a platform for further learning
- Provided an up to date live market assessment and application of newly acquired knowledge to a real time situation.
- Further information regarding research subscription and seminars can be found at [www.claradan.co.uk](http://www.claradan.co.uk)

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