

The conference was ably chaired and moderated by Arnold Wood. He planned the program, contacted all the speakers and ran the show, very ably. Audience estimated by me at 250 persons from US, Canada and as far away as Brazil.

Everyone received a workbook, with copies of the slides. In two weeks or so, Adobe downloads will be available. Let me know if you want a copy or perhaps some should be posted on the Applied Behavioral Finance Group of the Chartered Financial Analysts Los Angeles website. The resume of all speakers is on the CFAI website. Each topic or presenter was given one hour with 30-45 minutes of formal presentation, and written questions read by Arnold Wood. There is information on the websites of all the speakers, and most of their publications.

Speaker 1: Richard Zechhauser, Harvard Professor: He spoke on LESSONS FROM Behavioral Finance.

He spoke on observed behavior of Analysts, Money managers and corporate behavior. Behavioral Finance thrives when there are market disequilibria. He said if there were not strong behavioral tendencies in investors, the audience would not be there.

You need Behavioral Finance to capitalize on your own investments and to counsel clients. He reviewed the behavioral propensities as Biases, Anchoring, Overconfidence, probability bias and group processes. He showed probabilistic decision-making trees. He spoke on risk assessment in bold and cautious investment strategies.

He showed the merging of the real world of finance and the psychologist's world of biases and perceptions. He spoke about the economists work, but felt that Behavioral Finance was the merging of Psychology and Economics, which together explains the anomalies in investing to which we attribute Behavioral Finance.

He demonstrated experiments, which showed the narrowness of investment thinking by individuals. He spoke about optimistic personalities and overconfidence being linked.

Probability Bias: Individuals assess probabilities based on their values and experience. You can see how this leads to behavioral misperceptions. He spoke on the relationship of short-term volatility and its relationship to long-term probabilities. Loss Aversion: people avoid small losses much more than seeking small gains.

He spoke on actions that looking back will prove valuable in investing such as, mutual fund flows, flows to varying sectors, flows to and from emerging markets and hedge funds. In a year or so, how will we look back on those current issues, which seem so appealing and best places to invest today!!

There are decisions to the benefit of the SELF and decisions to be made as an AGENT: These are different. You can comply with client thinking or guide client thinking.

He did a side-by-side comparison of Rational Investing and Behavioral Investing:

Rational Investing: involved steady state decisions, recurring situation, and continuous allocation, ect. Behavioral Investing: involves adaptive, unique and strategic issues.

He gave examples of how one can CAPITALIZE ON BEHAVIORAL DECISIONS.

1. Economist David Ricardo became rich on going against the crowd betting on bond prices on the eve of a battle that could determine who won a war.
2. Buffett bought up earthquake risk, when other insurers backed off following a major earthquake, where insurers took losses. He figured he would win as a Contrarian, and he made billions on that transaction. But he had the security of capital behind him
3. We as individual investors can bet on P/E's or small vs. large caps or investing in the unknown such as biotechs or mining stocks.
 - He concluded by pointing out lessons in Behavioral Finance, such as learning to exploit situation and investing in areas you understand, and in understanding and communicating the needs of clients

- The first step is knowledge, then understanding ones biases and finally, knowing yourself and correcting your biases, if possible.
- He said stay away from investments where the knowledge of others is superior!!
- And steer into the areas where there is limited competition.
- Do not assume that because you do NOT know the risks involved, others do. Such as Russian Investment, War outcomes, if you think you know, you may be the sucker.

Speaker 2: Michael Mauboussin. As Chief Market Strategist at Legg Mason, he is involved with everyone managing money at Legg.

He tried to explain Market Efficiency, but saw them as complex adaptive systems. Aside from psychology, he introduced Social Psychology and Sociology in the decision making process. He felt the markets are broadly efficient, but with periodic opportunistic excesses or extremes.

He also pointed out that some investors outperform, most are average, and the majority under performs.

He reviewed the authors and contributors to affianced market theory, but pointed out that there is irrational investor behavior somewhere.

He quoted others in saying MET may be a poor theory, poor enough to invalidate it. Financial success is a theory of “sharks” and not a theory of rational man. He quoted persons who said MET advocates work hard to rid the field of sensitivity to the psychological vagaries of investors.

He gave an interesting example, with Long Term Management. As spreads widened and opportunities appeared, arbitrageurs backed away further and further from investing until the situation collapsed. Theoretically arbs should have embraced an opportunity.

Wisdom of crowds: Large numbers of people always come closer on average to estimates of “everything” than individuals. Collective error is always less.

Exception to that are the Bubbles” Tulips, South Sea and Internet! The Behavioral Extreme Examples

He discussed the Asch experiment, as did several other speakers. Google Solomon Asch for further information. [His classic experiment on perception]

Other point out seeing believes what others tell you are seeing. More diversity Breakdown is seen in magazine covers which point out Oil Gluts at market bottoms ect. Real estate scares at real estate bottoms.

Crowds are wise at times and foolish or misled at times. Markets are often efficient and occasionally not. It is very, very hard to go against the crowd.

Speaker 3: Andrew Lo. MIT lots of articles and information on his website. He pointed out that neuroscientists are just now making models of how financial decisions are made based on brain anatomy

His articles are on his website. It was an excellent presentation.

He prefers to use the term which he had Coined of the “ADAPTIVE MARKET HYPOTHESIS.” [AMH]

HE POINTED OUT:

1. Individuals act in their own self interest
2. Individuals make mistakes, sometimes lots of mistakes
3. The heuristic or pattern in Behavioral Finance is competing drives
4. Evolution dictates market dynamics more than we realize

AMH: survival of the person is all that matters and adaptation and innovations are keys to survival in the animal or Darwinian sense.

Again I recommend his website, as he was an exciting speaker and MIT professor.

Speaker 4: David Porter. Porter is an experimental psychologist who has run bubble experiments in a laboratory for two decades. He traced how

inexperienced traders always poorly estimate market tops, but as experience comes in, they learn, but then get out too early. Even insiders can benefit, but they can't time the market or benefit from bubbles necessarily.

1. Great stock market booms are driven by waves of new technology: the railroad, the radio, the automobile, and the computer, the internet.

- But these new elements come with great uncertainty and unpredictability
- These new elements attract massive amounts of new liquidity.

Speaker 5: Nicholas Barberis. His website at Yale, and prior work from Univ. of Chicago are worth seeing.

EMT is the traditional theory. Behavioral Finance theory offers good alternatives
Kahneman's prospect theory kick started the movement

Stocks with higher volatility have lower returns. There are all sorts of psychological studies that are being tied into financial theory, right now. People will pay to avoid electric shocks [or maybe other financial shocks]

Many of these studies will shed light on financial puzzles, like IPO pricing and performance, momentum, equity premium and others.

Behavioral decisions for corporations involve whether to issue stock or buy back stock. These decisions are made with uncertainty.

Speaker 6: Terrance Odean. He is an acknowledged expert, perhaps the supreme expert on Individual Investor Behavior.

He looks at investing as "bets" or gambling, since you are betting on a future outcome.

The trading decisions of individual investors are biased by all sorts of issues, such as avoiding regret, wanting to be part of the crowd, limited attention and knowledge, chasing trends, ect. A common anomaly is money pouring into last years winning mutual funds.

Noise trader's choices perform well for about 2 weeks, but under perform in the next few months. Informed traders push prices back to fundamental value

A question to be answered: Do institutional investors benefit from superior information or from the mistakes of individual investors. Well worth looking up his publications. He demonstrated in his presentation that he knows a great deal about how individual investors think and how they invest...and lose in the long run.

Speaker 7: Michael Ervolini. Cabot Research: His firm is hired to go in and examine underperforming fund managers and determine how they are violating their own trading rules. These usually turnout to be their own biases. he explained the process by which they come in to a money management situation, and through software analysis can tell an employer how their manager is not doing what they say they are doing. It would be hard for me to apply what was told to me, but it is starting to be done: Analyzing the analysts. Companies are trying to identify behavioral biases in their money managers.

Speaker 8 Jason Zweig: Check his very interesting credentials. He is learning about brain anatomy and seeing areas of the brain light up when financial decisions are made or the same decision is done without thinking. A lot of decision making is subconscious or unconscious and occurs without the decision maker even being aware of their actions.

There are issues where greed, prediction, confidence, surprise, fear, regret and happiness reside in the brain where decisions are made not using facts, but deep seated emotions.

He demonstrated a lot of knowledge of brain anatomy and function. He talked about neuro-anatomical evidence that the expectation of being right, and the experience of being right are activated and registered in different parts of the brain. And where the sensation of being in control is part of brain function. [Who wants to feel out of control?]

He showed that perception is sometimes quite wrong. There is an experiment that several speakers referred to where words are shown on a screen, the word red shown in red, the word blue shown in blue. Now when you start to mix up or change these, i.e. the word red appears in blue, and the word green appears in

yellow ect. your rational mind cannot function and you get confused stopped or blocked.

The part of the brain having to do with risk perception and fear is in a primitive subordinate part of the brain not in the cortex, and it never gets into consciousness, so risk is perceived at a subconscious level, although rational reasons can be given by the reasoning, rational or cortex part of the brain.

conformity reduces anxiety and the brain can rest. It hurts to step out of the herd.

His conclusions were to pay heed to your brain and realize that's where poorly controlled biases exist. Everyone comes to finance with their poorly controlled biases thinking they are in control of their decision making.

Simon and Schuster will publish his book on the subject, "YOUR MONEY AND YOUR BRAIN" in September,2007. He is also a columnist for Money magazine and knows a heck of a lot about investment professionals and their failures.

This concluded day one.

Day 2 Speaker 1: Burton Malkiel. Princeton Economics Professor, Author of a Random Walk down Wall Street. Ninth edition just published.

Professor Malkiel is a dyed in the wool, Efficient Market Theorist pioneer. However, and amazingly, he has identified and acknowledged Behavioral Finance and now includes a chapter in his 9th Edition.

he compared EMT and Applied Behavioral Theory. he acknowledges both. Within Behavioral Finance resides the irrationality, where prices deviate from fundamental value and markets become inefficient on occasion.

He spoke about biases:

Overconfidence: many people have an illusion of skill and overestimate their abilities.

Growth stocks are usually overestimated and overvalued.

There is a bias belief in momentum. short selling is much more difficult than imagined.

Behavioral Finance offers some good contributions:

Avoid herd behaviors: the most important lesson

avoid overtrading: current portfolio management is 100% per year. This enhances probability of underperformance.

If you trade, sell the losers and keep the winners [the tradition bias is vice versa]

There is a timing penalty: cash is low as a rule at market bottoms.

An interesting chart based on his research showed that value stocks as shown by percentage closeness to market PE [P/E's low at market bottoms] demonstrates that value is low now, and was highest in 2001 at the market bottom. You would have to see this chart to understand it, I can't describe it well.

Mutual funds under perform the market. Many speakers alluded to this finding. Mutual funds do not survive because they under perform. Same with money managers and advisers. This was overall an excellent presentation by a legend, and his 9th edition and current appreciation of Behavioral Finance make the book worth reading or owning.

Speaker 2 John W. Payne: Psychology of Group Decision-making, by a psychology professor. He spoke on committee decisions. Diversity is a key

A committee of any sort that is congruent [everyone of the same age, same sex and same beliefs] is probably an ineffective committee with "yes men."

Best committee decision making is when youth is represented and varying points of view. The committee chair should have the least to say until all others have committed their ideas a perceptions. If the senior member of leader expresses his beliefs, other will probably agree, and the benefit of diverse perceptions would be eliminated.

A well constituted committee makes the best decisions. this is well proven.

This of course applies to financial decision making committees.

Speaker 3 Justin Wolfers. Prediction Markets.

This was an unusually and highly interesting presentation

Based on EMT. the question came up, why do they often fail:

Professor Wolfers studies prediction markets where player place money bets on future outcomes. Las Vegas betting on sports, and political elections are uncannily accurate.

he has followed inning by inning bets on baseball games, and bets on long shots and favorites. According to his graphs and charts, the betting public is essentially correct. If a candidate has 3:1 odds on winning an election, those are probably the correct odds. he showed many charts of betting results from the Academy Awards to baseball games. The California Gubernatorial race showed the correct outcome on Schwarzenegger.

Wolfers believe the answers to why these prediction markets are so accurate lies in the science of behavioral economics.

He showed how when Howard Dean lost his temper during a speech, his odds started dropping precipitously and determined he was irreversibly out of the presidential race.

Since 2001 and with the market going up, the equity market discounted the was, Saddam, oil shock ect, and the market kept going up. The market knew things would be OK despite the lost list of “worries”

Right now the prediction market shows that if the democrats win, it will be Hillary.

He feels **prediction markets** are real, because money is bet on them, and that is sincerely “putting your money where your mouth is.” He feels this is a pure form of Behavioral Finance.

Presidential election betting of the early 20th century was a precursor to the invention of polling.

Can prices or markets be manipulated? Traders who manipulate, create opportunities for the best informed.

Check out his website and articles for explanations better than I can provide.

[www.nber.org~jwolfers](http://www.nber.org/~jwolfers)

<http://bpp.wharton.upenn.edu/jwolfers/index.shtml>

Speaker 4: A Panel. this panel took written and oral questions of a general nature from the audience and was oriented mostly to individual questions of the audience rather than specific issues.

Again, check out the websites.

Also, thanks to Charles Henneman of CFA Institute, I am authorized to distribute the slides of all presentations to only our Applied Behavioral Finance Group Board members.

Arnold Wood, after meeting with Mark Harbour and I sent a proposed program for CFALA Applied Behavioral Finance Group to put on.

I will send the slides after the board meeting next week.

Respectfully submitted,

Larry Brody
Secretary
ABFG Board