



This Month

Is there a link between aviation and behavioral finance? It sounds crazy, but Dan Pomerantz, the President of the ABFG, makes a very good case for it in this month's article. Also check out the links for two of Richard Thaler's classic papers on behavioral finance.

Behavioral Parallels Between Investing and Aviating by Dan Pomerantz, CFA, ABFG Board President

Visual flight rules (VFR) are a set of regulations which allow a pilot to operate an aircraft in good weather, i.e. one in which he can see the horizon. This is the first level rating for a pilot and requires some ground school, passing an exam and a minimum of 40 hours of training in the air. To obtain this license the pilot must understand how to operate the plane, navigate, communicate on the radio, understand weather and airspace, file a flight plan, read instruments and handle emergencies. That's quite a lot for 40 hours.

The next level license is called the instrument rating or IFR. This allows a pilot to fly under conditions in which flight by outside visual reference is not safe, i.e. to fly by instruments rather than by looking outside. This takes an additional 40 hours of simulated or actual instrument time. Why would it take 40 additional hours to learn to read a few more instruments when in the first 40 hours you can learn basically everything else?

It's because our brains are wired for a different world than the one that exists today. Over thousands of generations we have refined our instincts of fight or flight. Our instincts and our intuition have served us well over the past ten thousand years. It has kept us from getting eaten by predators and has allowed us to act quickly and opportunistically when necessary. But these same instincts handicap us when we try to fly a plane or when we try to invest rationally.

One day my flight instructor asked me to put on a hood, one that looked like a large baseball cap. I could see the instrument panel but the windshield was blocked by the hood. He asked me to close my eyes for a few minutes while he stealthily manoeuvred the aircraft.

Newsletter

This is a monthly newsletter from the Applied Behavioral Finance Group (ABFG), An Associated Group of the CFA Society of Los Angeles, CA.

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Mission

To identify, evaluate, and disseminate information and activities in the field of behavioral finance. Our objective is to enhance collaboration between research and practitioners in order to produce practical applications of value for investors and professionals who serve them.

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<http://www.abfgla.com/>

Then he told me to open my eyes and fly the plane. I could not see the horizon, just the instruments. The instruments told me that the airplane was descending at 800 feet per minute and turning right by 20 degrees. But my brain told me we were level. I struggled to move the plane such that the instruments would be happy. Once the instruments looked right my body felt very wrong. I thought we were climbing too quickly and the airplane would stall. I was physically uncomfortable. After a minute I reverted back to what felt right. Then the instructor asked me to take off the hood. When I did I saw that we were descending and falling to the right.

He wanted me to see first hand that my instincts were not to be trusted. If wanted to overcome my faulty instincts I would need to take the additional 40 hours of instrument training. That's what would be required to "un-wire" my brain to fly by instruments. In the meantime I should stay away from clouds.

Investors face similar challenges. Watch mutual fund flows and you'll see how money flows in during rising markets and out during falling markets. Our instincts guide us to do exactly the wrong thing. See the attached graphic.

If we were planning to buy a refrigerator, we would be more likely to buy one during a sale. That's rational. When the price is lower we are more likely to buy and when the price is higher we are less likely to buy. But with financial assets it's exactly the opposite. When the stock markets rally we feel optimistic and greedy and are more likely to make a purchase. Inversely, during times of market decline, the impulse to sell is incredibly strong. Think about October 2008 and what your instincts told you to do. Instincts will lead you astray.

Behavioral finance helps us understand our limitations and challenges as investors. One of the greatest services a financial advisor can provide to clients is to save them from themselves. Create a long-term rational plan and help the client stick with it. Create impediments to acting impulsively. Frame the conversation properly. Redirect attention to what matters. Keep clients in their seats.

It can take more than 40 hours to "un-wire" an investor's brain but, as with flying, failure to do so can have catastrophic consequences.

Websites/Links of Interest

Two of Richard Thaler's classic papers on Behavioral Finance

[Does the Stock Market Overreact?](#)

[The Nominal Share Price Puzzle](#)

Upcoming Events

We'll have more ABFG sponsored speakers later this year. More information will be posted soon.

Editor's Invitation

Please write with any ideas, articles, rants, raves about our newsletter etc. to: Editor, Applied Behavioral Finance Digest to: editor@abfgla.com

We also invite you to view our website, www.ABFGLA.com , and share your thoughts and ideas.