



PSYCHOLOGICAL ASPECTS OF INVESTMENT DECISIONS

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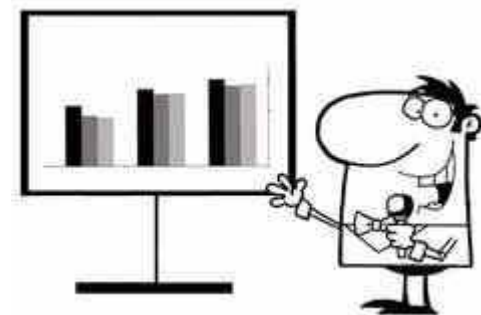
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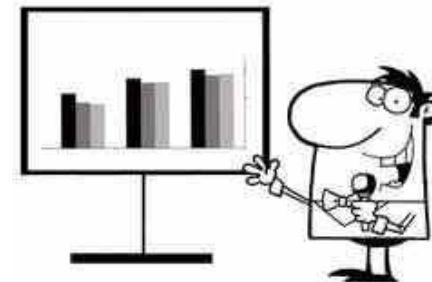
A projekt az Európai Unió támogatásával, az Európai Szociális Alap társfinanszírozásával valósul meg.

Structure of the presentation

- Motivation
- Explanations
- Illustration
- Unfolding the bugs
- Solutions

Motivation

- Changing nature of finance: dominant role of market-based financial intermediaries.
 - The aggregate balance sheet in 2007 17.000 trillion \$ \leftrightarrow commercial banks 13.000 trillion.
 - Were deeply involved in securitisation and actively used capital and financial markets to satisfy their funding needs \Rightarrow are very sensitive to changing market conditions.

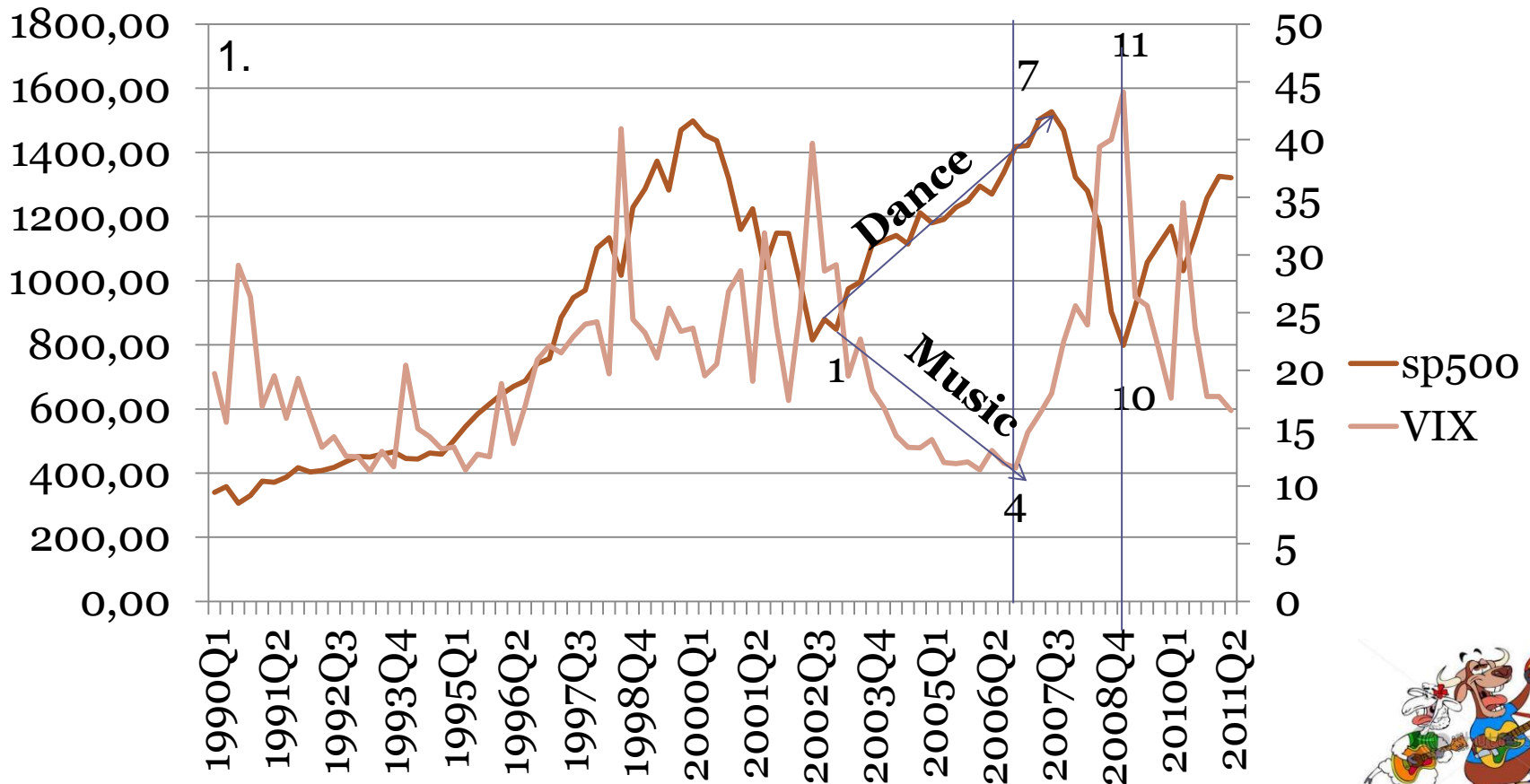


Explanations

- Behavioral economics:
 - Heuristics: market-makers – fast information processing \leftrightarrow growing amount \leftrightarrow speed; news hierarchy (Fromlet, 2001; Kahneman – Tversky, 1974)
 - News re-confirmation, place of publication (DellaVigna, 2007).
 - Post-earnings announcement drift.
 - Anchoring – technical analysis, stop-loss.
- Interest conflict
 - 2 dimensions:
 - Time: short \leftrightarrow long,
 - Organizational: individual \leftrightarrow organisation \leftrightarrow society.

“As long as the music is playing, you've got to get up and dance.”

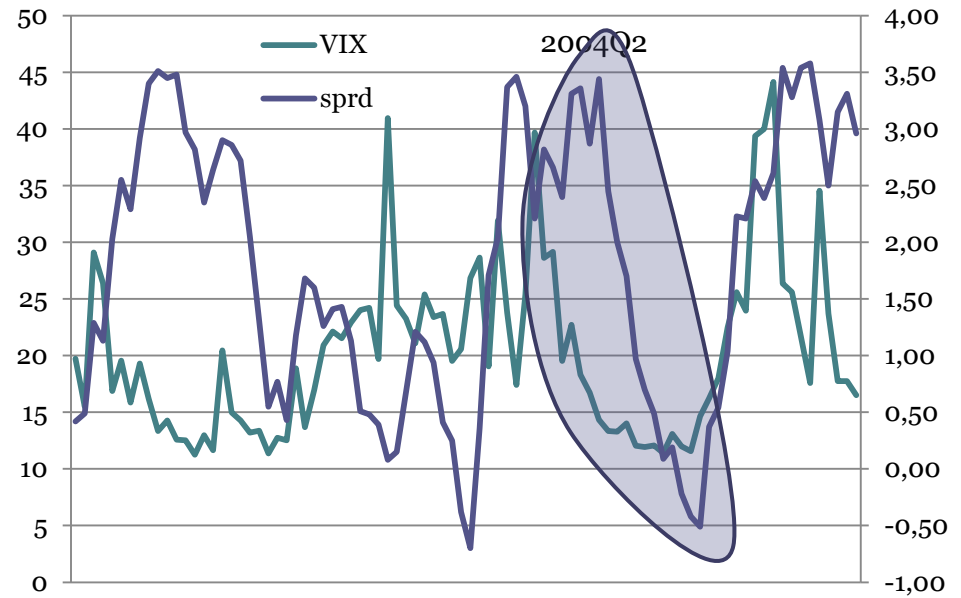
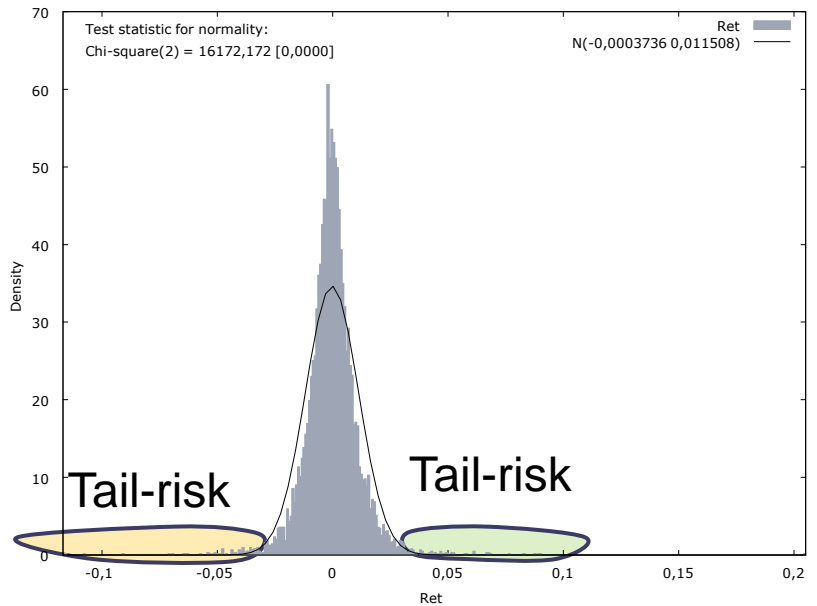
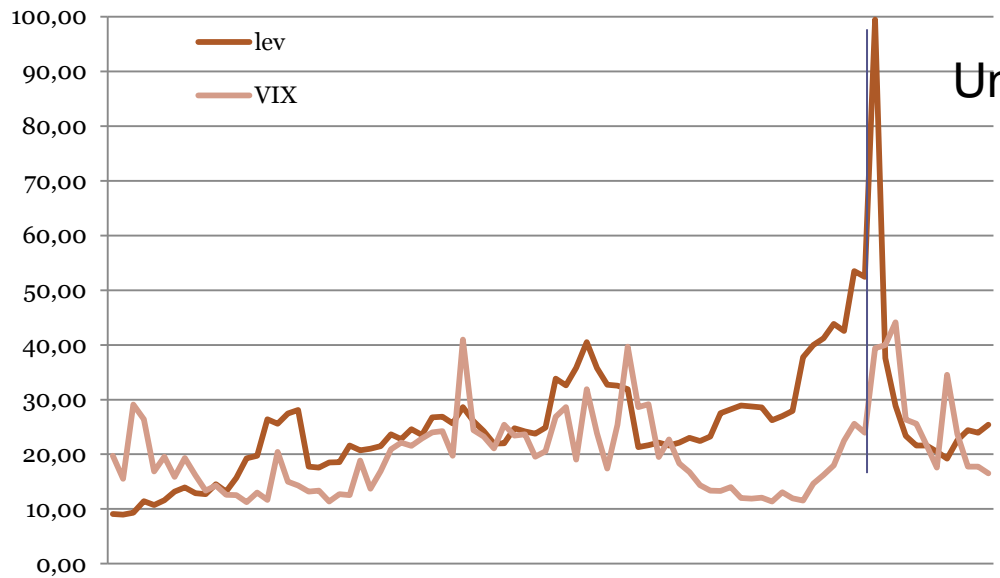
Citigroup's chief executive, Charles O. Prince



The vicious circle

- Perceived Risk \uparrow :
 - VIX \uparrow \rightarrow unintended leverage \uparrow \rightarrow deleverage \rightarrow prices \downarrow mark-to-market \rightarrow shrinking capital
 - Haircuts/ margins \uparrow \rightarrow liquidity \downarrow
 - Feedback between shrinking liquidity and prices \rightarrow panic exacerbated by mark-to-market





The bug - compensation, psychology



- Flawed compensation schemes.
 - Short term focused:
 - Incentive for traders to take (tale)-risks.
 - They do not risk their own money, but earn well (10m \$).
 - Market-risk premium and risk-adjusted performance not fully recognized by the system.
- Psychological effect:
 - Herding behaviour – Keynes.
 - This time is different.
 - Risk managers and warnings are scarcely listened to in good times.

The bug - industry specific

- Managers' and regulators' limited knowledge .
 - Regulators lag behind markets, financial innovations.
- Cheating.
- The reaction functions are very similar.
 - The common use of VaR and markets connects business players; $1+1 \geq 2$.
- Markets are connected \rightarrow spill-over effect between markets and countries.
- Upward-Sloping Demand Reaction functions.
- Short-term financing - illiquidity appear remote.

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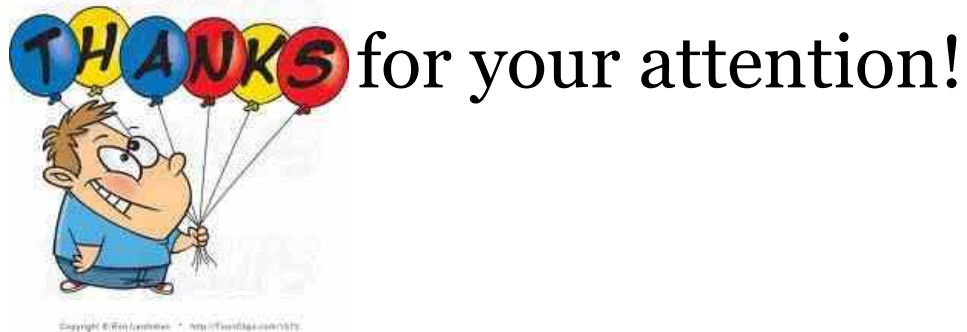


"And in conclusion, perhaps a change of business model is in order."

Solutions

- Counter cyclical rules.
 - Capital and liquidity buffers in Basel III.
- Mark-to-liquidity.
- Stress-VaR and stress tests.
- Stop intense maturity transformation.
- Longer time horizon.
 - premium practice, stock options on long horizon, compensation fund.
- Better regulator monitoring.
- „VaR is the worst form of risk-management, except for all those other forms that have been tried from time to time.,, Churchill.





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