Beat: Business

Behavioral Finance and Modern Finance By Ferdinando Lettieri

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USPA NEWS - Let's hear what Ferdinando Lettieri, a great expert in behavioral finance and investments, has to say. He always has useful advice on how to manage investments wisely and rationally, taking into account the emotional and behavioral aspects that can influence financial decisions.
"Behavioral finance is a discipline that studies how people make financial decisions based on their emotions, attitudes, and behaviors. In practice, it analyzes how psychological factors influence individuals' financial choices.

This discipline was born in the 1970s and has gained increasing importance in recent years, as it has shown that financial decisions are not always rational and based solely on mathematical calculations, but are often influenced by emotional and behavioral factors.

For example, behavioral finance has shown that people often let themselves be influenced by emotions such as fear or greed in their investment choices, and that they can be subject to cognitive errors that compromise their financial decisions.

In summary, behavioral finance helps us better understand how the human mind works in money management and how we can improve our financial decisions by taking into account these behavioral factors.

Modern Finance and Behavioral Finance From the pioneering work of Louis Jean Baptist Bachelier, The Theory of Speculation of 1900, modern finance began to take shape. After the study of the French mathematician in economics, a well-known physical phenomenon, Brownian motion, was used as a model to analyze the evolution of prices in the stock markets. Now in the past fifty years or so, a new and fascinating discipline has emerged, an intersection between psychology and economics, known as "behavioral finance."
From Modern Finance to Behavioral Finance: The use and abuse of the word "Diversification" In the last 40 years, Modern Finance has been based on the principles dictated by Markowitz, which earned him the Nobel Prize in Economics in 1990.
Markowitz said: “A good portfolio is something more than a long list of good stocks and funds. It is a balanced set that provides the investor with protection and opportunity against numerous contingent factors.”

So something more than the abuse that, for commercial reasons, is made of the word "diversification."
This word is often used, especially in recent times, to introduce products that are not very "good" into the list, accompanied by the phrase “from a diversification perspective…”, or even, “within diversification it fits.”
I personally disagree. A good portfolio should be seen as a good fruit salad, made of good fruit. I have never heard that an unripe or rotten fruit fits well in a fruit salad.
Markowitz also said that, since the investor is rational, he does not like risk unless the game is worth the candle. For an “excellent portfolio,” in addition to diversifying, one must look at correlations, that is, how each investment moves as the others move.
One of the greatest followers of Markowitz, who immediately applied his theories, was, in the mid-1970s, fund manager Peter Lynch, who later became the greatest fund manager in history.

The fund managed by Lynch, over fourteen years, from 1977 to 1991, had an average annual return of 29%. It beat the American index thirteen times in fourteen years. Or as if, betting fourteen times on a number on roulette, one guessed it right thirteen times. Almost impossible!
After 14 years of managing the fund, Peter Lynch left the business, dedicating himself to philanthropy.
The reason he left, perhaps, was not only philanthropy. The fact that, despite investments made in his fund doubling in value on average every 2.5 years, over half of the fund's investors, precisely 52%, LOST MONEY.
It was Lynch's experience that led, from the mid-1990s, to a new branch of Finance: Behavioral Finance. This led scholars Daniel Kahneman and Vernon Smith to share the Nobel Prize for Economics in 2002 thanks to their psychological theories in economics.

It was time to recognize that, without the psychological basis, the economic theories of the last century could not stand.

Kahneman stated that the individual was not as Markowitz wanted him to be, rational, but rather "normal."
The individual is repetitive, intuitive, and emotional, which depends on the fact that there are two distinct areas in his brain. This is very well described in his book “Thinking, Fast and Slow.”
One part of our brain is always awake: the repetitive, intuitive, and emotional one that does not need energy to activate.
The other part is lazy: the rational one, which needs a lot of energy to activate.
The use of the emotional part often leads us to make mistakes.
As proof of this, I propose an exercise:
a pair of shoes and a ball together cost 110 euros. The shoes cost 100 euros more than the ball. How much does the ball cost?

Give yourself the answer first and then continue reading.
This is one of the games that I often propose in the evenings when I try to demonstrate the importance of Behavioral Finance. The answer seems very simple. And it is. However, over 90% of the people, precisely because it seems obvious, get it wrong! The reason? It is elaborated by the part of the brain that is always active, the intuitive one. Since it seems simple, there is no need to wake up the rational hemisphere.
Oh, by the way, the correct answer is not ten euros, but five euros!
Sometimes it is as if our brain is in "airplane mode" or "offline," we let the rational part sleep.
All this to say that it is absolutely common for all people to have a rational and emotional part. The important thing is to be aware of them and manage them. Emotions help us make decisions that reason sometimes cannot make.
An example is the "paradox of Buridan's donkey." The hungry donkey to whom the owner had placed two "identical" piles of hay in front of him.

The donkey, devoid of emotions, spent the whole night choosing the stack of hay; not noticing any differences, he did not choose and died of hunger.
Oscar Wilde said: "The advantage of emotions is that they deceive us."
Indeed, they help us in choosing (not always for the best, but they help us).
There is no need to undergo a magnetic resonance imaging while making economic decisions, just start using some precautions.
One precaution is to avoid the behavioral errors that I talk about in an article on my Facebook page.
A good exercise can be to focus for a few seconds and ask yourself: “am I deciding with my brain, my heart, or my gut?”
Just the thought has the effect of turning the key in the ignition switch of the car: it starts the rational hemisphere, on-line mode.
In reality, many books on economics as far back as in past centuries talked about this aspect.
These, which I will discuss in other articles, have been the reference points for investors like Warren Buffett and George Soros".

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