Brent Sheather's RESEARCH

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Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

BEHAVIOURAL FINANCE AND THE ESG HUSTLE: Part 1 Rehearsing the Basics

One of the godfathers of behavioural finance research, Hersh Shefrin, Professor of Finance at Santa Clara University, California, recently published his take on the ESG investing phenomenon in the Journal of Investing. Professor Shefrin's paper, ESG and Behavioural Finance: Why ESG Investing is Primarily a Psychological Phenomenon, looks at ESG through the lens of behavioural finance, and it's findings will be covered in Part 2 and 3 of this series. It's refreshing to see a heavy hitter like Professor Shefrin take the other side of the ESG trade by suggesting that the popularity of ESG relates to intangible benefits (feeling good) as a result of financial firms' marketing efforts and that "investors are vulnerable to biased judgements about ESG impact and return distributions". Shefrin's scepticism is shared by another leading academic- Professor Aswath Damodaran of New York University, who has been a vocal critic of the financial sector's mercenary approach.

Shefrin has long argued that markets aren't efficient, simply because investment decisions are made by humans who are influenced by emotions like greed and fear. Psychological factors permeate finance and the rapture around ESG is one of the most visible iterations of this phenomenon. Before we get into all that this week we will rehearse some of Shefrin's behavioural finance research. Back in 2001 I reviewed his, then new, book on behavioural finance, "Beyond Greed and Fear". The following is an excerpt from that review of more than 20 years ago: Shefrin summarises the three major themes of behavioural finance:

⊂ **Heuristic – driven bias**

Investors make mistakes because they rely on "rules of thumb" to process and simplify data and decisions. A good example is "past performance is a good predictor of future performance so one should invest in the managed fund with the best five year record". This "rule of thumb" provides a simple and easy way to pick from the multitude of managed funds but nevertheless is usually wrong. Another way that investors simplify the decision process is to focus on dividends rather than factoring growth and risk etc into their valuation methodology. Looking at the dividend is easy and we have covered this problem before in this column.

Shefrin details a number of common heuristics including excessive optimism, hindsight bias, overconfidence and representativeness. An interesting example of representativeness is known as the "gamblers fallacy". Gamblers' fallacy arises because people misinterpret the law of averages eg if five tosses of a coin all turn out to be "heads" what is the probability that the sixth will be "tails". The answer is still 50% but many people (including this silly writer) would have said a higher figure because they think the law of large numbers applies to small samples as well as large samples.

⊄ **Frame Dependence**

Frame dependence suggests that the way that a problem is framed or described impacts investors perceptions of risk and return. Loss aversion is a good example of frame dependence: Researchers estimate that a loss has about 2.5 times the impact of a gain of the same magnitude. Many private investors find it difficult to sell any investment at a loss prompting one expert to comment that "get evenitis" has probably wrought more destruction on investment portfolios than anything else. As we will see in Parts 2 and 3, the vendors of ESG products use opaque framing in their marketing techniques.

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- **Inefficient Markets**

Shefrin's final major theme is simply that the effect of heuristic driven bias and framing effects is to cause market prices to frequently deviate from fundamental values. Shefrin's view is that the market for ESG products is particularly inefficient.

A follow-up story, also in 2001, examined some of the practical applications of behavioural finance and how a knowledge of common investor weaknesses might be used to enhance decision making:

- **Overconfidence**

Shefrin reckons that overconfidence is one of the most strongly documented behavioural biases and is a prime reason for poor investment decision making. Researchers have found that one of the reasons investors are reluctant to sell their loss making investments is because it requires them to admit a mistake which could lead to a loss of confidence. For the same reason investors overweight information which supports their own views and filter out conflicting reports. Further evidence suggests that overconfidence influences the judgement of investors more when they are analysing vague subjective information. Experience is also a factor – research indicates that inexperienced investors are generally more confident of their ability to beat the market than longtime investors. Some of my clients who, despite not knowing a dividend yield from a basis point, are very confident that by investing along ESG guidelines they will achieve better returns and make an impact.

Shefrin proposes an additional reason why some people trade so much: "they are motivated to master their environment and it is unpleasant to believe that one has no control especially where chance and skill elements coexist. Investors who are high in the desire for control and suffer from the illusion of control are prone to trade frequently". Entrepreneurs, owner-managers and successful business people often have trouble investing relatively passively in that they see investing as another business which must be mastered and controlled.

- **Failure to Diversify**

Combine optimism and overconfidence and it is not surprising that a good proportion of private investors fail to adequately diversify, despite all the theory urging one to do so. They believe that a good understanding of a few stocks (their portfolio) is a better risk management tool than diversification. This behavioural attribute is exploited by many financial advisors who recommend "ten good ESG compliant stocks" out of 200 (also good) stocks. Unfortunately many of the latter frequently turn out to be "better stocks" and some if not all of the ESG compliant stocks have pretty obvious links to naughty stuff.

- **Home Bias**

Compounding the "failure to diversify" problem many investors, even though they knew that their own country's stockmarket represents only part of equity universe, tend to concentrate their holdings in their home market. This is not a huge problem if you live in the USA (70%+ of the world stockmarket) but can cause all sorts of problems if you live in a small place, without any investor protection laws and dubious management like …. NZ. Apparently, Shefrin says, Europeans buy European stocks, Japanese buy Japanese stocks etc. Why? Familiarity. Behavioural finance theory tells us that investors have a natural aversion to ambiguity so tend to "stay at home".

That's it for today – next week we will check out Shefrin's review of the ESG hustle using his behavioural finance framework.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.