Behavioral Finance and Multi-Factor Investing

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PNC Capital Advisors Advantage Equity Team

The study of behavioral finance, which examines the psychology behind investor decision making, is now a standard component of modern portfolio management. However, the recognition of behavioral finance by academia has been fairly recent. In fact, foundational work in the field originated outside finance completely and was only later applied to investor behavior. For example, one of the pioneers in behavioral finance was Daniel Kahneman, a psychologist, who won the Nobel Prize in Economics in 2002 for his groundbreaking work in this field. Kahneman's initial work focused on the military, healthcare, and sports. But as Kahneman and others learned, the investment field is rife with some of the most obvious examples of cognitive biases that can hurt a person's decision-making abilities.

We have to look no further for evidence of the harmful effects of human bias in investing than to the frequent underperformance of active asset managers relative to major indexes over long time periods. In an attempt to avoid this seemingly predetermined fate, many within the industry have adopted the lessons of behavioral studies in an attempt to enhance rational investment decision making.

Those who argue for a passive investment approach will say that markets are efficient, that new information is priced into the market too quickly to take advantage of the new data, and as such, an investor shouldn't bother trying to beat the market. Behaviorists would offer a different view. They would argue that all investors are subject to inherent biases, which causes them to fail to maximize their returns. Some common examples of these cognitive biases are:

Anchoring: People are over-reliant on the first piece of information they hear.

Availability Heuristic: People overestimate the importance of information that is easily available to them.

Confirmation Bias: People tend to listen only to information that confirms their perceptions.

Overconfidence: People are too confident in their abilities. Experts tend to be more confident than laypeople.

There are many other cognitive biases, too many to list. Cognitive bias is essentially a pattern of deviation in judgment that occurs in particular situations, leading to perceptual distortion, inaccurate judgment, and just plain irrationality. Collectively, behaviorists would argue, biases are the reason investors, both lay and professional, are not adept at selecting stocks that outperform the broader market over time.

If you accept that argument, then one would conclude that being able to minimize the negative effects of behavioral issues could be as significant as the investor's method of selecting securities. Maybe beating the market isn't an issue of more or better information, but rather it's the discipline in implementation. To beat the market, it's not a matter of knowing more than anyone else, or having better ideas about certain securities, the key factor is having a disciplined process designed to build a portfolio with characteristics that have a positive correlation with improving stock prices.

AVOIDING BIAS DEFINES OUR APPROACH

Active portfolio management must be able to add value, net of fees, to the investor in order to compete with the returns of passive index strategies. We believe our approach of factor-based investing is the way to add sustainable value. Our process is centered on an investment strategy in which we choose securities based on quantifiable attributes that are associated with higher returns. This requires detailed analysis to determine distinctions between factor drivers and their correlation to excess returns.

Analysts have a tendency to fall for the power of a narrative. That's why we believe the basis of security analysis should be constructed using an objective lens and rely on facts and procedure. The fallacy of abandoning evidence in favor of a good story is associated with people's vulnerability towards over-interpretation. This is generally how investors find themselves chasing returns, which inevitably fall back towards relative valuations. The goal of the Advantage Equity process is to keep these subjective factors in check.

THE ADVANTAGE EQUITY PROCESS

Our process starts with our multi-factor model. It ranks securities within our investable universe using growth, value, and quality factors; factors which are quantifiable, based on sound academic evidence, and have shown strong historical correlations with predicting stock price movement. Equipped with this quantitative assessment, we then conduct a fundamental analysis of the securities to make an investment decision. Imperatively, it is the data which drives our decision-making process. Portfolio construction takes into account our reward-risk framework and adheres to the sector guidelines suggested by our multi-factor model.

Behavioral finance plays an important role throughout our investment process, but it plays a particularly significant role as we monitor the holdings in our portfolio. Our investment criteria are strict, and if a security violates our investment process, it will be removed. In our view, we are able to minimize cognitive biases and narratives through the objectivity of our process and the minimization of subjective inputs. It's these same foundational principles that we believe make our process highly repeatable.

Behavioral biases, coupled with advanced degrees and industry credentials, can be a toxic combination if one is not careful. We believe that in investing, adherence to a process ultimately dictates success. As professional investors, it is central to how we invest client assets. It's important to remind ourselves that we can't intuit relationships between factors and we're subject to narrative biases, so we would be better served by focusing on objective analysis.

None of us are here to say that we're immune to these biases. In fact, we're habitual offenders. What's important is that we stay committed to our process. It can be agonizing to miss a big inflection in a stock price based on a company's latest narrative. However, we remind ourselves, if it is truly impactful, the opportunity will express itself in earnings expectations and we'll pick it up on our model. If we ignore our process, we risk experiencing a dislocation between the stock's price and it underlying economics. To that effect, we intentionally don't know the price of our stocks as we analyze them, but we do know their factor scores.

KUDZU OF THE MIND

The year 1876 was not only our country's first centennial, it was also a year that lives in infamy for many southerners. Let us explain. Kudzu was introduced from Asia to the United States at the 1876 Centennial Exposition in Philadelphia. It is a Japanese vine that is ornamental in nature, can shade porches, and can be very effective in managing soil erosion. For laudable reasons, it flourished during the Dust Bowl of the early to mid-1930s.

The problem is that kudzu is also very invasive. It can choke off ecosystems, destroying native plants, including trees. It is also immune to most commercial herbicides. We may not have realized its deleterious effects for decades, but today, kudzu is facetiously referred to as the "vine that ate the South," due to the South's favorable climate that fuels its broad-based infestation.[1] People have learned to control kudzu by physical means, but it is a relentless commitment.

How is this relevant to behavioral finance? Because we believe behavioral biases can be thought of as the "kudzu of the mind"—they won't go away, you need to control them, and it requires an arguably lifelong commitment. If we accept this reality, we're better able to stick to dispassionate, objective decision making, which is one of our core tenets of investing. And yes, we keep our metaphorical "sickles" handy at all times.

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[1] In many respects, Kudzu suffers from its own narrative biases. Bill Finch's September 2015 Smithsonian Magazine's article, "The True Story of Kudzu, the Vine That Never Truly Ate the South" (http://www.smithsonianmag.com/science-nature/true-story-kudzu-vine-ate-south-180956325/), objectively explores the myth versus reality of Kudzu. It may be a decent metaphor, but it's not as invasive as many believe.

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