Investment News

Monthly Bulletin from the Investment & Risk Team

March 2015

Last Month in Brief

Uncertainty surrounding the Greek bailout and, ultimately, their membership of the Eurozone eased somewhat at the end of the month as Germany's parliament (who's approval was seen as crucial) voted in favour of extending financial aid by a further 4 months.

The FTSE reached a new record high in light of the easing worries about Greece, oil prices and, significantly, expectations of continued accommodative monetary policy in light of low inflation and stuttering global economic growth.

Annual UK CPI fell to just 0.3% in January and the Bank of England expects that inflation is likely to fall further and could temporarily turn negative. However, Mark Carney believes that the low inflation observed in recent months is temporary and is largely due to falling food and oil prices. Importantly, he stated, there is no evidence of deferred consumption, a damaging symptom of deflation, but noted that the Monetary Policy Committee remains vigilant to the downside risks and would cut interest rates if necessary.

The US joined much of Europe in experiencing negative inflation, with the annual inflation rate falling to -0.1% in January. The Federal Reserve's Janet Yellen reported that they are 'flexible on rates' with unemployment still too high and wage growth sluggish. This had a buoyant effect on US equities with both the Dow & S&P reaching record highs.

Chart 1: Equity Indices

Equities experienced gains during February

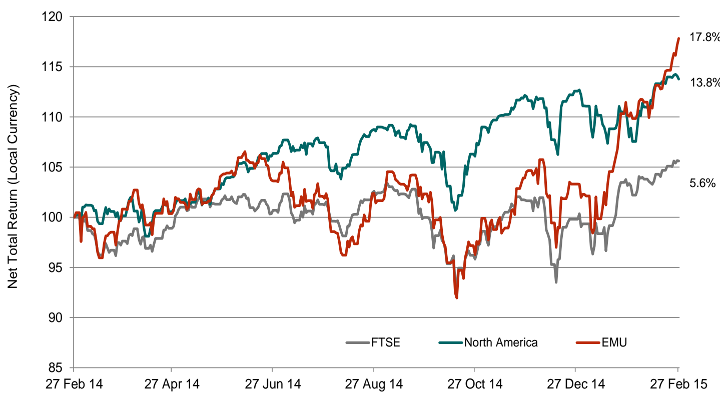


Chart 2: Sterling Credit Spreads

Credit spreads narrowed during February

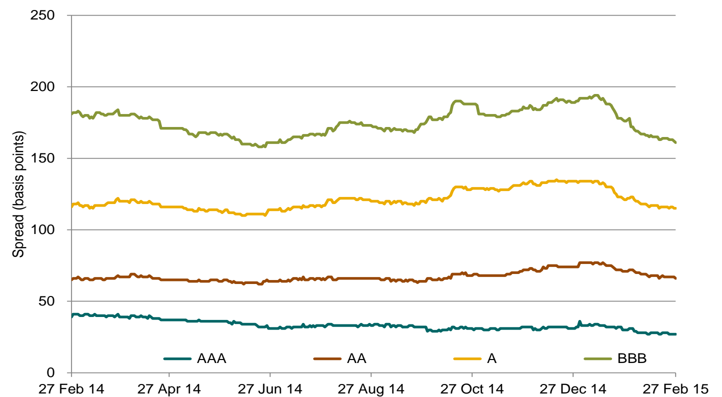


Chart 3: Gilt Yields

Gilt yields have risen this month

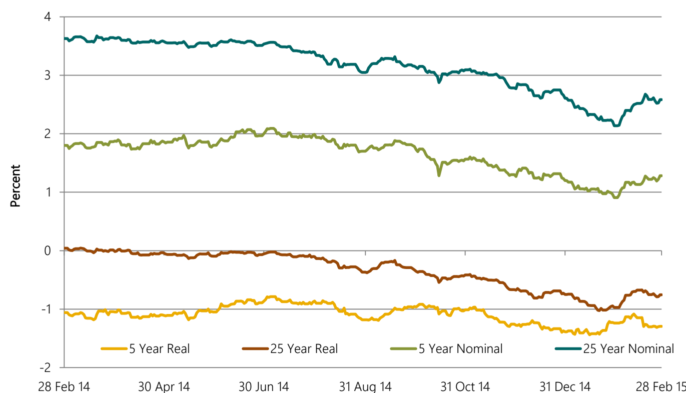
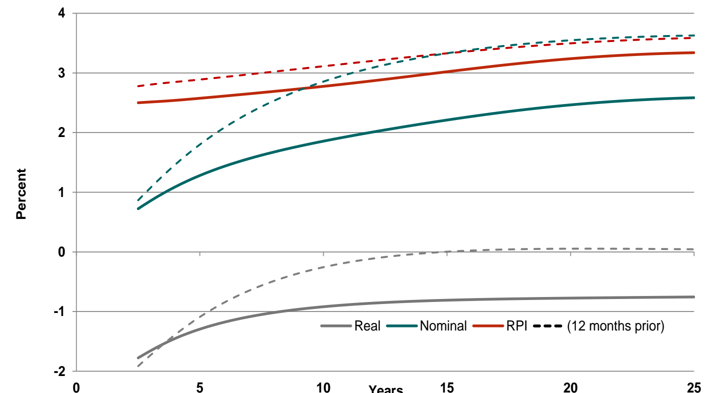


Chart 4: Gilt Spot Curves

The nominal yield curve steepened during February



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.3%	0.5%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	77.6%	82.3%	**QE Level**	£375bn	£375bn
Halifax house prices (monthly change)	2%	0.9%	**VIX (volatility) index**	13.34	20.97
IPD TR property index (monthly change)	0.8%	1.6%	**$/£ exchange rate**	1.55	1.50

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Behavioural finance

The rational behaviour of an investor is often regarded as a fundamental assumption in modern financial theory. Despite seeming intuitive, the validity of this assumption is often questionable as decisions will be often be influenced by a range of drivers.

Behavioural finance aims to explain the psychological factors that are believed to influence decisions made by market participants. There are a number of theories that seek to explain 'irrational' behaviour, some of which we have considered below.

Why consider these theories?

Behavioural finance offers an insight into the factors that may shape decisions made by market participants. Having an awareness of these influences may assist our judgement and lead to the development of more informed and balanced decisions.

Financial anchoring

The foundation of any decision will be the facts that it is based upon. To arrive at an informed decision, the information available should be considered in a proportionate manner so as to avoid placing too much weight on any one contributing factor. Financial anchoring refers to the tendency of an investor to subconsciously 'anchor' their choice to a reference point, regardless of its relevance. Investors may move away from this anchor, based on new information available to them, but it is suggested that the use of an anchor leads to a bias in the decisions made.

An example of anchoring is in relation to asset valuation - an investor's valuation will often be 'anchored' by the price of a similar asset or the price derived from a model. Whilst the investor might adjust this anchor price, studies suggest that the adjustments people make tend to be too small.

Question framing

Perhaps the most widely acknowledged behavioural influence, question framing, suggests that the presentation of a question can help shape the answer (see box 1).

Box 1: An example of question framing

Research has shown that question framing can have a significant impact - for example individuals may be more likely to agree with a statement when it is presented as a single choice. The charts below show how the wording of questions can lead to quite different interpretations for the levels of support for an action.

In a study, participants were asked two questions:

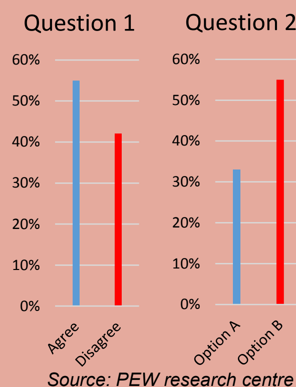
Q1 'The best way to ensure peace is through military strength'

Do you agree/disagree?

Q2 Which statement (A or B) do you agree with most :

A) 'The best way to ensure peace is through military strength' OR

B) 'Diplomacy is the best way to ensure peace'



Source: PEW research centre

Question framing is commonly applied through advertising leading to consumers having to question "why not?" try a new service or product. It might be a relevant factor for financial institutions to consider in their correspondence and interaction with members. Decisions made by members, for example with respect to their choice of funds in a DC scheme or the take-up of certain options, may be influenced by the way that such options are presented to them.

Prospect theory

Prospect theory analyses how investors make choices when faced with risk and uncertainty. It argues that individuals are risk seeking when considering losses but risk averse regarding gains (see box 2). This departs from the traditional assumption that an investor will always be risk averse. The implication of this theory is that investors will sell assets soon after generating a profit but hold onto them longer when suffering losses.

Box 2: An example of prospect theory

1) You have the option to receive one of the following payments:

A) a 50/50 chance to receive a payment of £1,000 or £0

B) a payment of £500 guaranteed

2) You are instead required to take one of the following losses:

A) a 50/50 chance to pay an expense of £1,000 or £0

B) an expense payment of £500 guaranteed

Prospect theory suggests that an individual would opt to receive a payment of £500 guaranteed in the first scenario. However in the second scenario, investors would risk paying £1,000 in a 50/50 gamble. Prospect theory is used to explain this discrepancy in handling risk.

Myopic loss aversion

Related to prospect theory, myopic loss aversion suggests that individuals tend to focus on avoiding shot-term losses, even if it is at the expense of long term gains. As a result, the attractiveness of riskier assets depends on the time horizon and a tendency to review portfolio returns and performance on a regular basis.

Myopic loss aversion results in a short term view when handling investments and can lead to divergence from the "bigger picture" strategy. To reduce this, the Kay review of UK equity markets and long-term decision making made a number of recommendations.

Overconfidence

This theory suggests that individuals place a disproportionate value on their own expertise and judgement when making a decision. Furthermore, it suggests that this discrepancy increases as the individual becomes more knowledgeable in a given subject. The theory would suggest that financial institutions should be aware of the risks of overconfidence and biases in the advice they receive from advisors or fund managers.

The effects of "hindsight bias" – events appearing more predictable after they have occurred, as well as "confirmation bias" – acknowledging only facts that support your point of view and ignoring other factors, are both considered to be symptoms of overconfidence.

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