should be done with a clear head, says **Helene Zampetakis**.

- Inconsistency, irrationality and incompetence, characterise investor decision-making.
- The prospect of a short-term reward can trigger impulsive behaviour.
- Financial planners should have decision-making frameworks that help them avoid mistakes.

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When (earlier this month) equity markets suffered their biggest one-day fall since the September 11 terrorist attacks five years ago, jittery investors, fearing the bull market had run its course, scrambled for the exits.

In fact, market pundits, such as David Cassidy, chief investment strategist for UBS Wealth Management, say the recent 10 per cent equity-market correction may be an ideal investment opportunity.

"You may not be buying with 100-degree certainty in today's market but, on balance, buying history suggests that (buying) is exactly what you should be doing."

But there's something about buying rapidly falling shares that goes against the grain.

"Buying stocks in markets that have gone down a lot, or selling high-performing shares, often feels hard to do."

Cassidy says that even professional traders find themselves straining to exercise logic when faced with monthly or quarterly figures, or when dealing with hedge funds, which are geared to short-term outcomes.

Indeed, evidence points to repeated inconsistencies, irrationality and incompetence in the way that investors arrive at decisions when faced with uncertainty.

The study of the psychology of investment behaviour is increasingly revealing why we invest as we do and how we can avoid making wrong decisions.

For generations classic economic theorists have held that markets are generally efficient – but prone to bouts of inefficiency – and that investors are essentially rational (albeit with a single decision-making system with in-built inconsistencies).

The recent use of functional magnetic resonance imaging to map activity in the brain when subjects take risky decisions shows a much more complex web of processes, with different decision-making systems competing for dominance.

The new discipline of neuro-economics has revealed, for example, that the brain functions radically differently when people attribute value to distant events, and to those in the near future.

One collaborative study last year between Princeton's Centre for the Study of Brain, Mind and Behaviour and Harvard and Carnegie Mellon universities showed that, when offered a choice, people will opt to make $1 in one day rather than wait a year for $1.10.

It found that, when a short-term reward is anticipated, impulsive behaviour is triggered by dopamine-related circuits in the brain associated with pleasure.

Says Dr Frank Ashe, who teaches behavioural finance at Macquarie University's Applied Finance Centre: "The parts of the brain responsible for these short-term decisions are the ancient parts of the brain dominated by the emotional side, whereas long-term decisions are [made in] the more rational side

> **'People will opt to make $1.00 in one day rather than wait a year for $1.10.'**

of the brain that has evolved over the past 200,000 years."

Investors are prone to a smorgasbord of other illogical tendencies when making risk-based decisions.

"Over-confident people – generally younger men – tend to overestimate their chances of success," Ashe says.

"People regret sins of commission more than those of omission, so prefer taking no action at all; with losses more painful than equivalent gains, investors tend to hold on to losing stocks for too long and sell winners too early.

"Most people seek out information that supports their point of view; traders tend to overestimate the likelihood of an event recurring, such as a large unexpected gain in a particular stock; analysts who visit a company have greater faith in its prospects.

"These behaviours are buried deep in the brain and we need to be aware that they are there," says Ashe.

"If you are a financial planner, you need to have your decision-making frameworks set up so that you have warning that you are venturing into these traps."

This is precisely what Darren Langer, senior portfolio manager at Perpetual, hoped to achieve by taking a course in behavioural finance in July 2005.

The course proved to be an eye opener.

"It shed light on why I had missed obvious indicators in the past, and why I had taken a view contrary to data that showed I was obviously wrong," says Langer

"It most definitely shed light on mistakes I had made."

Since then, Langer has applied this insight to his ongoing decision-making processes. "Behaviour can be modified," he says.

"With insight, you can take the emotion out of your decisions and look at why you have a particular point of view and whether you have the facts to back it up."

Investment psychologists say that, while it's difficult to see your behaviour objectively, it can be done if there are systematic frameworks to guide you through that process.

Ashe suggests regularly evaluating achievements and "revisiting catastrophes" to assess how you got there.

He also advises seeking out a wide range of opinions, including those that don't conform to yours.

While markets are not in our control, we can ensure that our interaction with them unmistakably is.