

December 4, 2017

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Profiting from Investor Misbehaviour

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All investors make errors which can often be traced back to a behavioural bias or emotional mistake. If under certain circumstances these mistakes are systematic, then it is not a stretch to believe we can develop systematic strategies to profit from them. After all, this is the essence of active portfolio management, finding mispriced assets and benefiting from them. We just believe a good source of mispricing are investors' emotional or behavioural mistakes.

One potential benefit of this approach is its longevity. Investors have been making emotional / behavioural mistakes in the market for over a century. In a very broad example, Warren Buffett's quote "Be fearful when others are greedy and greedy when others are fearful" is evidence that some have been profiting from other investors' behavioural mistakes for a long time. Although this is a very vague example. Instead, we endeavoured over the past year to find specific instances where it appeared an asset (stock, commodity, bond) was mispriced due to a certain behavioural biases, and created strategies to target the bias / mispriced asset.

On the following page, we share our strategy development framework and a strategy on which we have been working. This is for demonstration purposes only, and of course we would welcome any feedback from our readers.

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BEHAVIOURAL STRATEGY DEVELOPMENT FRAMEWORK

1) Find instances of behavioural bias

There are instances in the market place that certainly elicit more biased behaviour than others. Often these are emotionally charged times caused by a set of new information or changing sentiment.

When sentiment shifts, it can often trigger behavioural biases. Investors, in aggregate, tend to be susceptible to herd like behaviour. If it seems like everyone is doing something, there is a strong behavioural desire to join them. There are numerous biases behind this including confirmation, cognitive dissonance and fear of missing out. These are some of the biases that feed bubbles and bear markets. This can work in both directions, such as investors neglecting companies that have fewer buy ratings or are not in the media very often.

2) Evidence of market impact

This is the hard part – is the behavioural bias causing an asset to be mispriced and under what conditions? We researched a great number of types of scenarios or situations over the past decades where we had a strong belief investor biases were impacting behaviour. During this quantitative stage of our strategy development, we were looking for patterns of consistent mispricing of an asset and how the mispricing corrected over time.

It has to make sense intuitively. The quantitative research is important but the mispricing must be logical and potentially attributable to a behavioural bias.

Once a reliable pricing anomaly was found, our quantitative approach dug deeper analyzing how the anomaly acted in different market environments, across different sectors and for companies with different characteristics.

3) Develop trading strategy

Once a reliable mispricing anomaly was discovered, we then developed trading strategies designed to profit from it. The strategy optimization process is rather quant heavy and helped refine the strategy as to what kind of market is best or what kind of companies does the strategy have the most success.

The trading strategy was further refined to include stop-loss levels, trade duration and profit taking parameters. This helped further remove our emotions from the strategy implementation.

This was a very high summary look at how we develop and research new strategies. The markets are always changing and evolving which requires continuous adaptation.

FRAMEWORK IN ACTION – EARNINGS OVERREACTION

1) Instance of behavioural bias

When a company reports earnings, there can often be an overload of new information for the market to absorb. If the earnings are a big surprise, in either direction, this could cause emotions to become elevated, triggering increased biased behaviour.

We have found under certain condition there is a tendency for share prices to overreact to earnings. If a company is truly worth its future discounted cash flow for the next 10-20 years, why would one quarter carry such a big impact if they miss or beat expectation. This is the availability or recency bias in action, placing too much weight on information that is readily or newly available.

2) Evidence of Earnings Overreaction

We analyzed companies that experienced a big price reaction, either up or down, to an earnings report with the question: are investors overreacting to the newly available information? In some cases the answer was yes and in some no. The one which we will cover today is the overreaction to negative earnings surprises. We found that less volatile companies, which we bucketed as higher quality, seemed to recover well from the initial price decline. This was more notable compared to lower quality (more volatile) companies.

Intuitively this does make sense. A higher quality company misses earnings and its share price drops. There is more likely to be investors viewing the suddenly lower price as a buying opportunity in a quality company, thus helping bid the share price back up.

3) Trading Strategy

Potential buy ideas can be triggered by a higher quality company missing earnings and suffering a price drop. Further analysis was focused on the timing of the trade, shortly after the price reaction or waiting till end of day, plus whether the price reaction was counter or in line with the prevailing direction of the share price.

Finally, trade parameters were added including stop-loss levels and profit taking. Stop-loss is important as sometimes an earnings miss is just the start of something worse for a company.