AN INTRODUCTION TO BEHAVIOURAL FINANCE
Rationalising the irrational

WHAT IS BEHAVIOURAL FINANCE?

• An investment process based on the academically robust principle that market inefficiencies are a result of human behaviour
• A bespoke investment process that defines and measures specific behaviours
• Exploits the opportunities that arise from irrational decisions by others

Our process ranks stocks on three criteria aimed to exploit behavioural biases inherent in market participants:

1. VALUE
2. QUALITY
3. MOMENTUM

INVESTORS
INFORMATION CASCADE
LOSS AVERSION, HERDING

We believe investors tend to anchor on outdated information, remaining pessimistic about value companies, extrapolating earnings trends too far into the future. This drives a gap between price and fair value, creating buying opportunities. Conversely, investors tend to be overly optimistic about growth companies, creating selling opportunities.

COMPANY MANAGEMENT
ANCHORING
HERDING

Corporate management is prone to overconfidence and empire building, to the detriment of shareholder value. Companies with higher quality earnings and which exert greater capital discipline should outperform.

SELL SIDE ANALYSTS
ANCHORING
OVERCONFIDENCE

Sell-side analysts tend to herd close to consensus, leading to trends in earnings forecasts and additionally will anchor on prior views. Collectively these instincts lead to price and earnings momentum.
WE AIM TO IDENTIFY COMPANIES:

- That deliver consistently high returns on capital.
- Where management is disciplined with shareholders capital.
- Which generate sustainable high returns to shareholders.

UK HOUSEBUILDERS: 2007 – 2015

- In 2008/9, UK housebuilder shares suffered more than most from poor investor sentiment.
- Prices plunged to 50% or below of underlying book value as investors sold out.
- But our model showed that fundamentals remained strong and the sector recovered well, rising over 50% in both 2012 and 2013.
- Many UK housebuilder shares actually traded at less than 1x Net Asset Value during this period (see chart) meaning that the companies were bought for less than the value of their land and buildings, with no value being ascribed to the operational side of the business.

2. QUALITY | High quality earnings and disciplined management teams

FUNDAMENTAL INDICATORS OF QUALITY THAT IDENTIFY STRONG INVESTMENT PROSPECTS

WE AIM TO IDENTIFY COMPANIES:

- High quality earnings and disciplined management teams
- Capturing persistent business trends that the market may be slow to react to

3. MOMENTUM | Capturing persistent business trends that the market may be slow to react to

BUYING BUSINESSES WITH MOMENTUM THAT OTHER ANALYSTS HAVE BEEN SLOW TO APPRECIATE

- Trends persist for longer than the average investor expects.
- Our behavioural finance methodology can enable us to better anticipate future earnings changes.
- We aim to identify a stock’s potential value and invest in those with lasting momentum, not just short-term performers.