Behavioural Finance in Wealth Management

Master-Thesis

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Theme of study: Banking & Finance
Subject: Private Banking / Wealth Management

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Date of submission: 02.11.2013

Abstract

Based on structured behavioural finance framework, this thesis gives a well-founded overview of the major impacts of human psychology and behaviour on investment decisions, market anomalies and consequences on the wealth management process. The research sheds light on level of implementation of behavioural finance aspects in wealth management practice as well as the ability of behavioural finance insights to generate excess performance in the fund market by adaptation of its concepts to market analysis. By this approach the paper shows the potential and limitations of behavioural finance in modern investing and wealth management. Based on the findings of both qualitative surveys and interview as well as quantitative analysis of behavioural fund performances, the thesis concludes that behavioural finance, despite its academic importance, is not widely applied in wealth management and does not succeed to implement investment strategies that allow outperformance of the market on a expense and risk adjusted level.

Executive Summary

Research issue

Since the aggravation of market uncertainty during the recent crises traditional financial theories have once again been questioned in their ability to effectively predict financial markets and prize assets with sufficient accuracy. Many professionals raised the question whether the theories underlying modern portfolio and asset management account for market developments in a proper way or whether the aggregated form of individual investor behaviours deviated from rationality too much for efficient market behaviour to be existent. This problematic entails a lot of issues relating to wealth management on various levels, considering relationship management as well as market analysis and the construction of investment concepts. On the micro level individual habits and behaviours as well as psychological flaws call for adaptation in the advisory and risk profiling on a personalized level. On the other hand the increasing insights into market trends and anomalies that can progressively be explained by behavioural finance seeks way to be transformed into concrete financial solutions and improved market forecasts. While behavioural finance has been omnipresent in academic and evidential literature for over two decades, it remains widely unapplied in practice, which raises the question for reasons and motives behind such conservative attitude towards new insights.

Research objectives

Building on the surprising lack of implementation of the behavioural finance concept, which is so broadly accepted to explain a lot of the phenomenon traditional finance fails to explain, this thesis attempts to shed light on the reasons for this state and ways to account for it. With this main question in mind, the following three objectives have been targeted.
First of all, to enable a better understanding of the topic, the thesis aims to structure the abundance of different aspects in a clearly structured framework accounting for sources and occurrence of the single attributes. Second, it inspects the effect of behavioural finance on the Swiss wealth management sector by disclosing its influences, ways of application and state of use. The last goal is to show whether it is possible to achieve excess return from investments which follow the exploitation of misbehaviour in the financial markets in order to profit from market inefficiencies.

Approach and methodology

In a first step, based on the theories, models and empirical findings of the last decades a comprehensive overview of the theoretical basics of behavioural finance is given by a clear

definition, disclosure of recent development, classification of basic attributes and related issues. It is shown in what sense behavioural finance can generate insights beyond conventional financial theory and which are the main differences compared to the main theories. This introduction should clarify the relevance of behavioural finance and give the reader an understanding of basic underlying human behaviour in decision making situations as well as highlight issues and consequences for financial market developments.
In a next step, focus is set on the influences of behavioural finance on the wealth management process. After explaining the major implication of discussed biases and heuristics, the thesis discloses ways how behavioural shortcomings may be treated and how behavioural finance can contribute to improving the diverse functions in wealth management. Within the examination of behavioural impacts on the wealth management in Switzerland, a survey among the biggest and most renowned institutions of the sector was performed to get an impression of the level of implication behavioural finance has reached in practice and what attitude professionals have towards behavioural finance. Furthermore client risk profilers of wealth managers are investigated and screened for adaptation of behavioural influences. Third, to get an objective insight into the development and implication prospects of behavioural finance, an interview with Dieter Niggeler, the managing partner of Behavioural Finance Solutions, which is one of the leading Swiss institutions in transforming behavioural concepts into practice, has been undertaken. Finally, to check for the ability of behavioural finance to contribute value to investors in form of generating excess returns by exploiting market inefficiencies, a significant number of funds that base their strategies on behavioural insights analysed for their market-adjusted performance.

Results and conclusion

The findings and various insights from different academic as well as professional sources confirm the hypothesis that behavioural finance has not reached the level of practical application it should have, considering its popularity in theory and financial academics. Many problems and issues yet represent barriers that are not easy to conquer, among them the problematic of quantification of psychological and emotional aspects, the heterogeneity and inconsistency of human behaviour as well as the practitioners lacking expertise and willingness to align their processes to behavioural influences. Furthermore, the empirical research has shown that the inefficiencies in financial markets based on the aggregated irrational behaviour of individual investors currently cannot be exploited in an effective way. The reasons for this vary from the inability to detect anomalies, the costs of realization up to the question whether inefficiencies compensate each other by a degree that makes it unattractive to bear the effort and risk to hunt them down. Nevertheless behavioural finance does show the potential to create value beyond pure risk/return evaluation,