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Society of Registered Financial Planners

"HONG KONG UNDERGRADUATE FINANCIAL PLANNERS OF THE YEAR AWARD 2016"

(香港傑出大學生財務策劃師比賽)

Case Study

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Note: Your report must be written in English and no more than 15 single-sided, single-spaced pages (font size: 12-point Times New Roman), including cover pages, tables, charts, diagrams, references and appendices. Please submit the electronic file of your excel spreadsheets, if any, with your report.

BACKGROUND MATERIAL:

Conventional finance is based on the theories which describe people for the most part behave logically and rationally, such as Capital Pricing Asset Model (CAPM) and the Efficient Market Hypothesis (EMH). These theories explain only certain 'idealized' events but fails flat in many. People started to question this point of view as there have been anomalies, which are events that conventional finance has a difficult time in explaining. Like, many people dump thousands of dollars for a Mark Six, it does not make sense because the odds of winning is 1 in 139,838,160, they are not acting as rational 'wealth maximizers'.

In the 60's, three of the biggest contributors to the field are cognitive psychologists, Drs. Daniel Kahneman and Amos Tversky (they won the 2002 Nobel Prize in Economics Sciences), and Economist, Richard Thaler, who fit psychological theories into irrational behaviors. They are the founders of what today's BEHAVIOUR FINANCE is.
Anomalies push the need for new explanations in financial outcomes, to name a few: The January Effect (monthly return for small firms is higher in January than other month of the year), the Winner's Curse (the winning bid in an auction mostly exceeds the intrinsic value of the item purchased), Equity Premium Puzzle (investors that hold riskier financial assets should be compensated with higher rates of returns), etc. All these are well explained by Behavior Finance.
The major concepts of Behavior Finance are summarized below :

- The concept of Anchoring draws upon the tendency for us to attach or "Anchor" our thoughts around a reference point despite the fact that it may not have any logical relevance to the decision at hand. E.g. A Diamond Anchor, this is the most illogical examples of anchoring. By promotion, the conventional wisdom dictates that an engagement diamond ring should cost around two-month's worth of salary. Although the amount spent should be related to one's affordability, many men (USA) illogically anchor their decision to the 2-month standard (how about the Chinese Wedding Banquet!). In financial world, many investors anchor their 'price' on a recent 'high' of a stock and bet heavy when the stock drops, thinking about a 'discount'.
- Mental accounting refers to the tendency for people to divide their money into separate accounts based on criteria like the source and intent for the money. Furthermore, the importance of the funds in each account also varies depending upon the money's source and intent. Eg. Like instead of paying off the credit card loan, many keep a 'money jar' for 'emergency' even knowing that the loan interests is over 30% annually.

- Seeing is not necessarily believing, as we also have confirmation and hindsight biases. Confirmation bias refers to how people tend to be more attentive towards new information that confirms their own preconceived options about a subject. The hindsight bias represents how people believe that after the fact, the occurrence of an event was completely obvious. Many now claim that signs of the IT bubble in 2002, the USA 2008 Crash were very obvious, and this will lead to investors' overconfidence in stock-picking.
- The gambler's fallacy refers to an incorrect interpretation of statistics where someone believes that the occurrence of a random independent event would somehow cause another random independent event less likely to happen. In a series of 30 coin flips that all landed with 'head' side up, a person might predict that the next is likely to be 'tail' up. As a matter of fact, each coin flip is an independent event, turning head up is always 50, the previous flips have no bearing on future flips.
- Herd behavior represents the preference for individuals to mimic the behaviors or actions of a larger sized group. This may come from social pressure of conformity. The other reason is a rationale that it is unlikely such a large group could be wrong. One example is the Dotcom Bubble.
- Overconfidence represents the tendency for an investor to overestimate his or her ability in performing some action/task.
- Overreaction occurs when one reacts to a piece of news in a way that is greater than actual impact of the news. And it leads to Availability Bias, that they tend to heavily weight their decision towards more recent information. Like if you see a car accident along a road that you regularly drive to work, it is likely that you will begin driving extra cautiously in the few days following, although the road is no more dangerous than before. That is overreacting.
- Prospect theory refers to an idea created by Drs. Kahneman and Tversky that essentially determined that people do not encode equal levels of joy and pain to the same effect. The average individuals tend to be more loss sensitive (in the sense that a he/she will feel more pain in receiving a loss compared to the amount of joy felt from receiving an equal amount of gain). As an example, the amount of winning $100 should be equal to a situation in which you gained $200 and then lost $100. End result of both is a net gain of $100. But most people view a single gain of $100 more favorably than gaining $200 and then losing $100. This explains the occurrence of the disposition effect, the tendency for investors to hold on to losing stocks for too long and sell winning stocks too soon.

THE CASE

Now that you are fully equipped with BEHAVIOR FINANCE, how are you going to shape your financial planning technique so that in this era of extreme market turbulence with looming financial crisis in Europe, the USA, Japan, and China, you as a professional financial planner can convince a small family of four, both parents are in their early 50s and work as senior AOs in the HKSAR government with annual combined income of over HK$1.8M plus. The two kids are in their thirteen and fifteen studying in HK secondary schools. They are very conservative, like many middle-class in HK, worry about livelihood after retirement but on the other hand want to keep a comfortable lifestyle, a 1500 ft apartment (paid off already) and trips two three times a year.

Remember, the Brexit will mess up the Euro system, oil price keeps losing ground, war is looming in the Middle East and South China Sea. Worst of all, the bank interest rate and bond yields are low to negative return. No one single currency seems to be safe. Can precious metal go for a big bull market?

You probably have to be more aggressive in designing a portfolio so they won't lose money – now even buying treasury bonds, blue chips, and ETF, all are providing a negative yield. Should you or can you make them invest in more 'risky' portfolio? How?

NO NEED TO BE QUANTITATIVE. This case practice is about how you will exercise the best behaviour concepts in 'CORRECTING' the wrongness of most investors and financial planning in the PAST. Convincing cases and examples will give you more advantage in the competition.

