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*How understanding instability in financial markets can make you a better communicator*

Financial markets are inherently unstable. This is a statement of the bleeding obvious for investors left recoiling from the most recent financial crisis or hedge fund managers that seek to profit from its volatility, although you are less likely to hear the same words from your pension advisor or bank manager. At the heart of this instability is human behaviour, as recent turmoil in the financial markets attests.

Investment bubbles are rooted in human psychology, from Tulip Mania in the 17<sup>th</sup> century, the South Sea Bubble and the Mississippi Bubble through to the dotcom bubble and the bubble in US house prices and mortgage backed bonds. These catastrophic financial events have happened over and over again and, not only that, they are increasing in frequency. They are driven by herd behaviour - the tendency for individuals to mimic the actions of a larger group - and it has two main causes. Firstly, there is the social pressure to conform; humans are sociable and have a desire to be accepted by a group. Secondly, there is the rationale that such a large group cannot be wrong, and even an individual who feels a particular course of action is incorrect can get swept away by the herd believing it knows something they do not. For these people, there is also safety in numbers. If the bubble does burst, a money manager can justify his decision by pointing out how many others were led astray. It has also been argued that the tendency towards herding has been compounded by overconfidence as investing has become more professional. Mathematical models that measure risk with precision and show how to trade it for return were introduced by academics with a number of caveats. Investors, and other stakeholders, ignored the intricate and complex caveats and an impression that the markets could be tamed was created, which led to overconfidence. The latest bout of overconfidence was dashed when investors who thought the separation of risk origination and balance sheet management would distribute risk throughout the financial system suddenly found that enormous concentrations of risk had accumulated at its centre.

Herd behaviour and overconfidence are only two of the many cognitive traps that humans are prey to. To process the vast amounts of incoming information human brains receive, they use a set of compression schemes to abstract the critical elements. Essentially, information is simplified; but the process is subject to biasing effects and results in contradictory beliefs. One of the insidious things about cognitive biases is their close relationship with rules of thumb and mind sets that so often serve us well. Herd behaviour is a form of social bias, which involves striving for conformity and consensus. In the workplace seeking consensus is often not considered a failing, but a condition for success.

These biases distinguish real human beings from the economic man (*homo oeconomicus*) of neoclassical economic theory, who makes his decisions rationally, on the basis of all the available information and his expected utility. Models such as the efficient market hypothesis and capital asset pricing model are based on rational and logical theories and assume that people mostly behave rationally and predictably. While they do a pretty good job of explaining certain events, they are ill-equipped to deal with herd behaviour, overconfidence and other cognitive traps. A field of study called behavioural finance has grown, based on cognitive psychology, to account for the irrational and illogical behaviours that modern finance theory has failed to explain. The efficient market hypothesis and capital asset pricing model remain important, but as much for what they do not tell us as for what they do.

Forming a pivotal role at the point of interaction between a company and its investors, IROs will be more familiar with the shortcomings of these models than most. Daily interactions with analysts and investors will have given them first hand experience of decisions driven by emotion and psychology rather than objective analysis. The field of behavioural finance has been applied to decision making by investors but, as far as we know, it has not been applied to investor relations. And yet, this is the other side of the same coin and an appreciation of this subject can help IROs be more persuasive when they

communicate their investment proposition. If we understand a little more about how the brain processes information and the associated cognitive traps we can improve our communication skills.

This is the first in a series of briefings by Citigate Dewe Rogerson to help IROs take into account the cognitive biases revealed by behavioural finance. The methods outlined in the briefings will not prevent future bubbles, but they could make you a better communicator.

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## **Citigate Dewe Rogerson Investor Relations**

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Our dedicated team of investor relations consultants combines backgrounds in investment banking, equity analysis, fund management, accountancy and in-house investor relations to bring an unparalleled breadth of financial markets expertise and an in-depth understanding of the international investment community's IR requirements. Add to that our rigorous analytical skills and extensive access to the buy- and sell-side and you start to understand why we are consistently ranked among the leaders in our field.

Our independent strategic advice is exactly that - influenced by nothing other than our clients' best interests. And as a full-service consultancy, we also have the experience and technical - as well as human - resources to support a company's investor relations team in successfully executing its IR programme.

Our client list is drawn from all over the world and represents a wide spectrum, both in terms of industry and company profile. But they all have one thing in common: a desire for exceptional service and advice that is tailored to match their precise needs.

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