Principles of Finance last lecture

Brais Alvarez Pereira

The Efficient Market Hypothesis

Video

- Important theory saying that you cannot beat the market.
- Burton Malkiel and the Wall Street Dartboard competition.
- What do you think?

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In any case... you can always do worse than the market

Some -dangerous- behavioral biases I: cognitive biases

- We can´t be unbiased, but we can mitigate our biases if we can identify them. Cognitive biases as a rule of thumb which may or may not be factual.
- Confirmation bias: more weight on opinions which agree with yours.
- Gambler's (& hot-hand) fallacy: you short the S&P 500 because it has closed to the upside five days in a row. Past events do not connect to future events.
- Status-Quo bias: Habits. Coming back to the same stocks and ETFs instead of researching new ideas.
- Negative bias: More weight on bad news than on good ones.
- Bandwagon effect: WF "be greedy when others are fearful and fearful when others are greedy".

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Some -dangerous- behavioral biases II

Emotional biases: basing choices on feelings instead of fact

- Loss-Aversion Bias: Do you have a stock in your portfolio that is down so much that you can´t stomach the thought of selling? You don´t want to admit the loss has gone from a computer screento real money, and hold on in hopes that you will, one day, make it back to even. Show mine.
- Gain-Love Bias: the opposite of loss aversion, you have won $4000 with your investment and you feel you want to "cash-in" that profit $\Rightarrow$ selling too fast.
- Overconfidence bias: "I have an edge that you (and others) do not". Knowing some industry better, think you have found a pattern which others do not see... the market has made fools out of the most respected traders, it can do the same to you. Risks?
- Endowment bias: what we own is more valuable than what we do not. Remember that losing stock? There are others showing better health, but you still want to trust this one!

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Take action

- No way to eliminate biases. In investing, taking steps to minimize those biases is how the pros make money. Some examples of actions which help:
- Spreadsheet to calculate the risk/reward of every trade or investment. Set your threshold and never deviate from the rule (eg selling if loss> 5%).
- When you put a trade on, set an upside target.
- Bottom line: in order the minimize biases, set objective trading rules and never deviate. Overriding your emotions is a difficult task! ⇒Challenge!!

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Some lessons from your trading experience I

There were many more, I just particularly liked these ones

- Do not buy when a stock is at its highest price for the week.
- Refrain from purchasing many common assets.
- Commodities have a limited window of being traded.
- Buying commodities before they expire.
- Set a maximum loss per day that you can affort both mentally and financially to withstand.

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Some lessons from your trading experience II

- Invest in commodities (for example gold) when the economy is unstable.
- Do not invest in companies you think are cool: too much hype around them.
- Earnings season is a marathon, not a sprint.
- Be patient.
- Only short-sell when the intermediate term trend is down.

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Some lessons from your trading experience III

- Place bets that you know you can cover.
- Wiser to invest in a boring index fund than to invest with people who try to beat the market.
- While research is beneficial to see the trends in a company, people can react to those trends and provide an opportunity.

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What we have learnt

- The main concepts from finance: relative valuation, time value of money, NPV... in a perfect market environment.
- Understanding and applying these concepts and many important tools (eg. compounding, annuities) in practice. Mathematical exercises $\Rightarrow$ quantitatively systematic and rigorous.
- Trading in the stock market, reflecting about its nature, components, its main mechanisms and difficulties.
- Applying simple models to the stock market and capital budgeting.

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Other important concepts and ideas

- Uncertainty and risk aversion. Portfolio optimization and CAPM.
- Imperfect markets (frictions):
  - Disagreements.
  - Non-competitive markets.
  - Transaction costs.
  - Taxes.
- And finally:
- THE REAL WORLD!!!

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Hope you feel your foundations are robust