PROSPECTA briefings

The Winning Prospects of Prospect Theory

Kahneman and Tversky's Prospect Theory is a cornerstone theory in the academic discipline of Behavioural Finance, yet many professional investors do not see how it relates to their daily work, or how it can help them understand and predict asset prices. This talk will reveal what we consider to be the two most important practical implications of prospect theory in asset pricing: price momentum and investors' preferences for skewness in the distribution of returns.

Whatever your equity investment returns have been over the past 100 years, research has robustly shown them to have been markedly influenced by the persistent presence of price momentum. This is the tendency for past stock winners to continue to perform well, and for past losers to continue to perform poorly, over medium-term horizons (3-12 months). Yet despite more than thirty years of academic efforts to try to find an efficient-market explanation for the phenomenon, only positive momentum has been partially explained; negative momentum remains an enduring puzzle. We will reveal the human 'limits to arbitrage' that give rise to price momentum and allow it to be predicted.

Prospect theory also readily explains why investors have such a marked preference for strategies and securities that promise a tiny chance of making very sizeable gains, combined with little or no chance of incurring any significant losses. Buyers cherish this kind of returns distribution – known as a positive skew – to such a degree they are even willing to accept a negative expected return to be exposed to it. As skewness preferences can explain excess returns in risk categories as diverse as 'value' or 'market capitalisation', the chances are that if you do any asset allocation you are inadvertently also allocating for the market's expectations for the skewness of the returns distribution. This talk explains how these preferences arise and how they can be exploited.

The course instructor is Herman Brodie, founder of Prospecta. Here, and formerly as a director of Cognitrend GmbH, he has over the past 15 years advised some of world's leading financial institutions on behavioural finance and its applications. He previously held investment banking roles in London, Paris and Frankfurt. He studied Finance and Management at the University of Manchester.

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