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# Behavioral Finance

## Arbitraging Human Emotion

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# Objectives / Topics

1. Why understanding Behavioral Finance is foundational to sound investing.
2. Most common psychological pitfalls and tools to avoid them.

# Why is Behavioral Finance important?

Three types of investing edges:

- Informational** → *“I know something the average investor doesn’t.”*
- Analytical** → *“I understand something better than the average investor does.”*
- Behavioral** → *“I have more control over my emotions than the average investor.”*

# Informational advantages ...

**Exist when**

Investor knows more about a business / industry than most market participants and can profit from it.

**Gained by**

Scuttlebutt—unique/creative process to discover new information.

**Example**

**Uber**

unit economics

**Intrinsic value calculation:**

Access to algorithm

- Insiders
- Drivers

# Analytical advantages ...

## Exist when

Investor can process information better than most market participants to make better decisions.

## Gained by

Special degree / higher education (CFA or CPA)

## Example

### GAAP vs. Adjusted profitability

- Led to Embellishment and Protagonism

S&P 500 Index (2020 – 2024):

- # of cos. that adjusted earnings = 83% / 416
- Average adjustment / year = ~20% / \$560M
- GAAP losses → adjusted gains = 6% / 25

# Behavioral advantages ...

**Exist when**

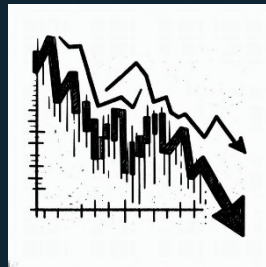
Investor can control their emotions better than most market participants during strenuous periods.

**Gained by**

Temperament—aware of the effects emotions have on our judgement.

**Example**

**Stocks vs. Socks**



From 1992 - 2023, average investor underperformed the S&P500 by nearly 1,000 percentage points.<sup>1</sup>



Annualized return: = 7.48%  
(\$10,000 grew to \$87,153)



Annualized return: = 10.14%  
(\$10,000 grew to \$181,281)

Human psychology is the main factor:

- Financial markets fill us with emotion.
- Heightened emotion → irrational behavior.

<sup>1</sup>Returns include dividends reinvested  
Source: Unison, J.P. Morgan, Dalbar, Bloomberg

# Why act irrational if emotional?

**Mismatch theory:** behaviors that were crucial for survival continue to influence our actions today.

Tribal  *polarization*

Food preference  *diabetes and heart disease*

Losses vs. gains  *hyperactivity and timing*



# A simple experiment.

I hand each of you \$100.

**Option A:** I flip a coin.

*Heads* → *I give you \$100 more (total \$200).*

*Tails* → *You return the \$100 (end with \$0).*

**Option B:** You keep the \$100.

**Loss-aversion:** pain from loss is more acute than pleasure from gain.

Evolutionary basis:

Marginal downside of loss is greater than the marginal upside of gain

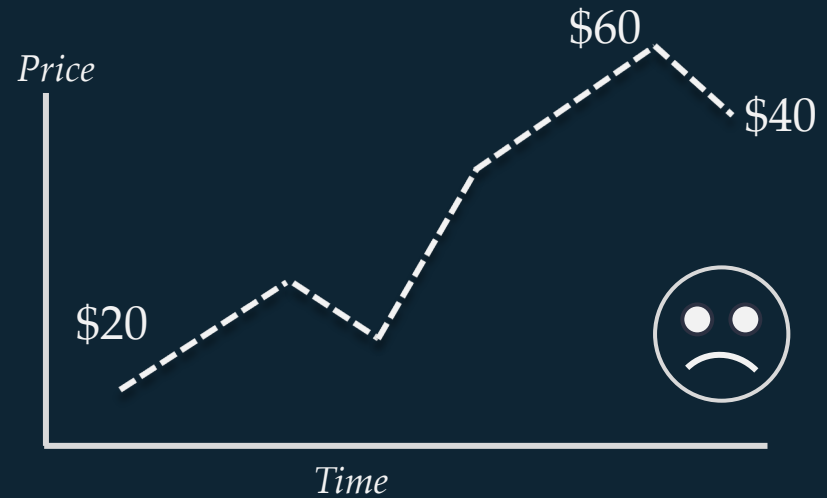
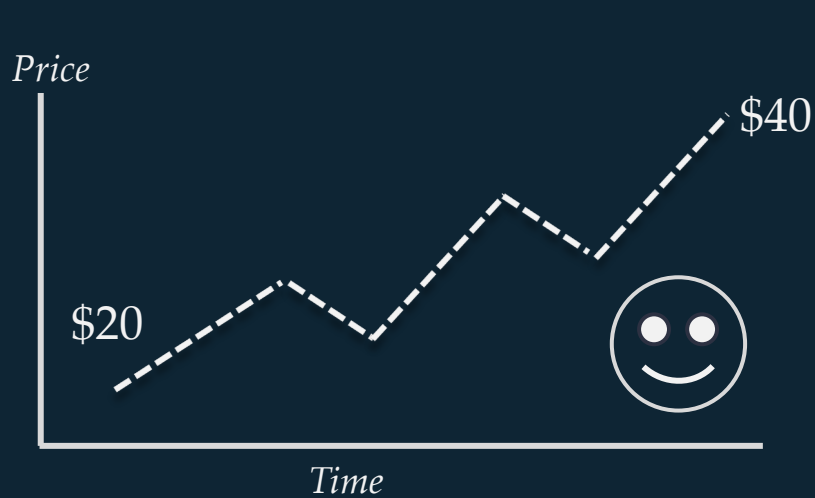


We subsist daily on 30 oz. of water:

50 oz. = *no difference*

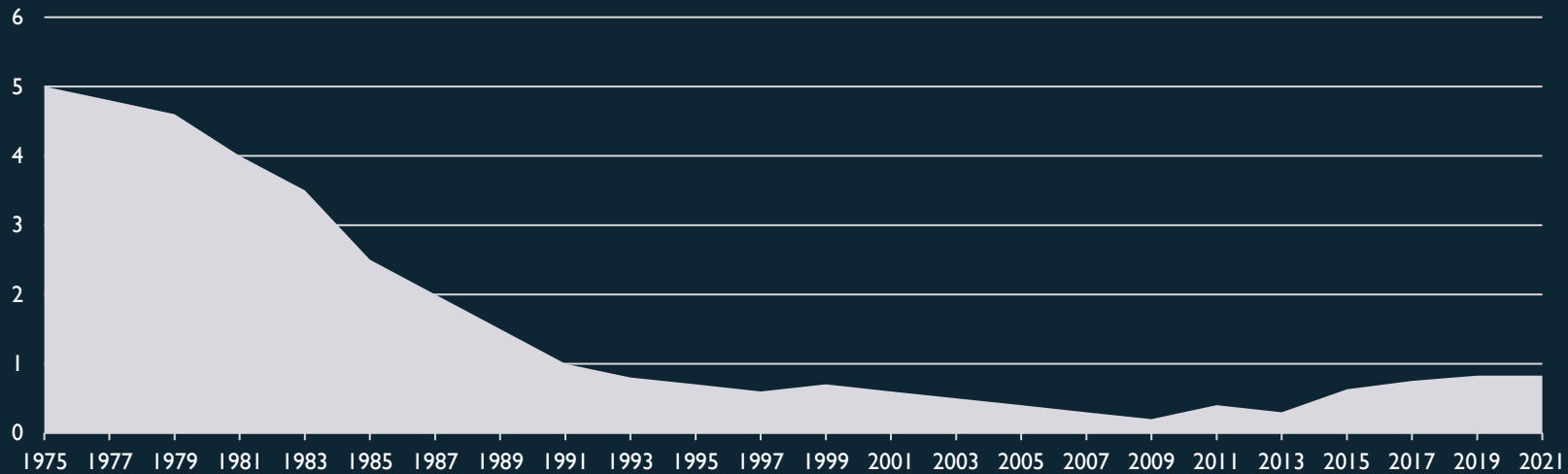
10 oz. = *existential threat*

# Investors are more sensitive to relative than absolute outcomes



# This quality makes us hyperactive investors

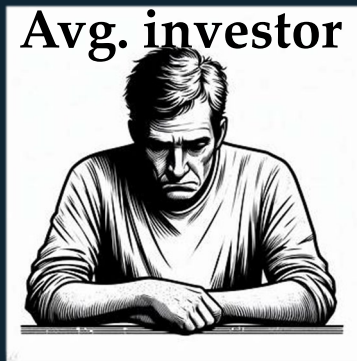
Avg Holding Period of a Stock is 10 Months



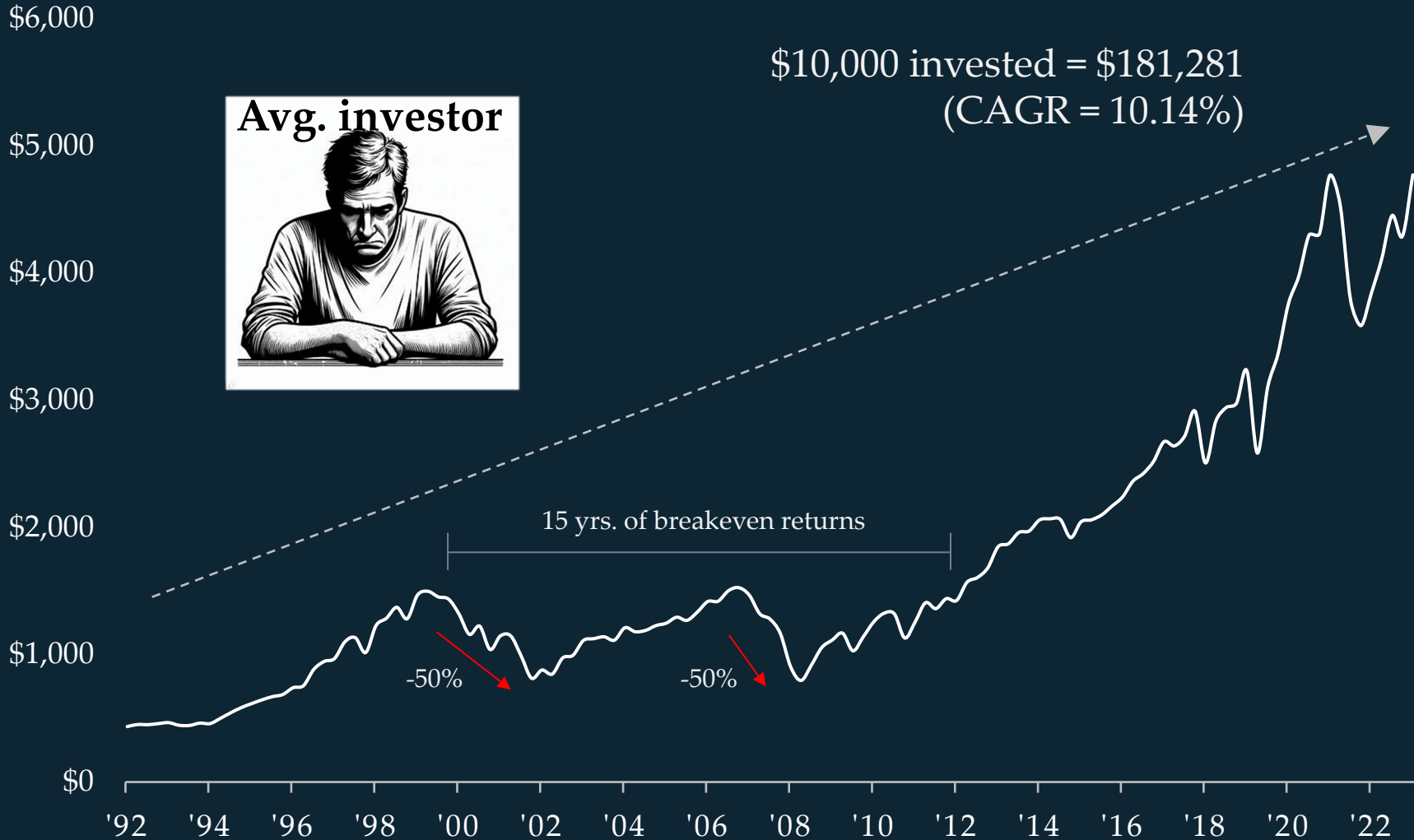
Source: Unison; NYSE and NASDAQ market capitalization divided by total turnover value.

# Investing is hard. Very hard.

## S&P500 INDEX (1992 – 2023)

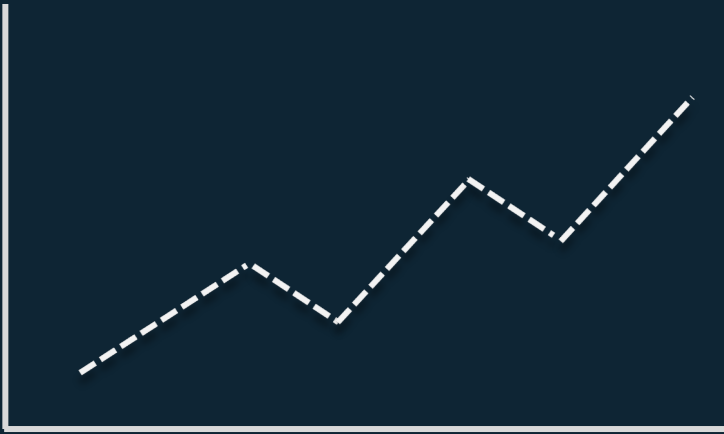


\$10,000 invested = \$181,281  
(CAGR = 10.14%)

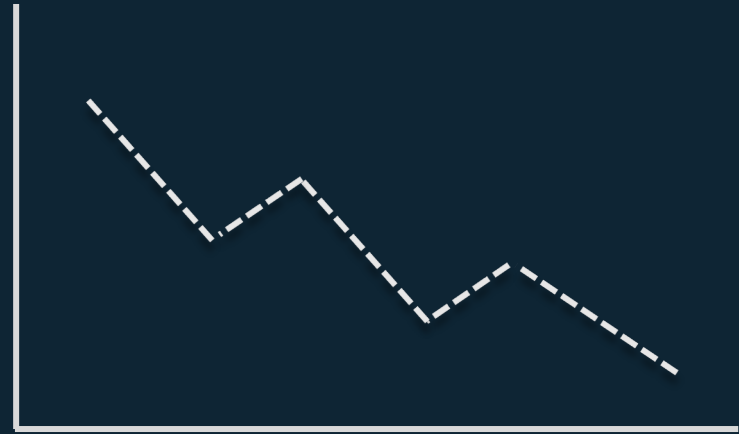


How do we manage this?

# Develop emotional acuity.

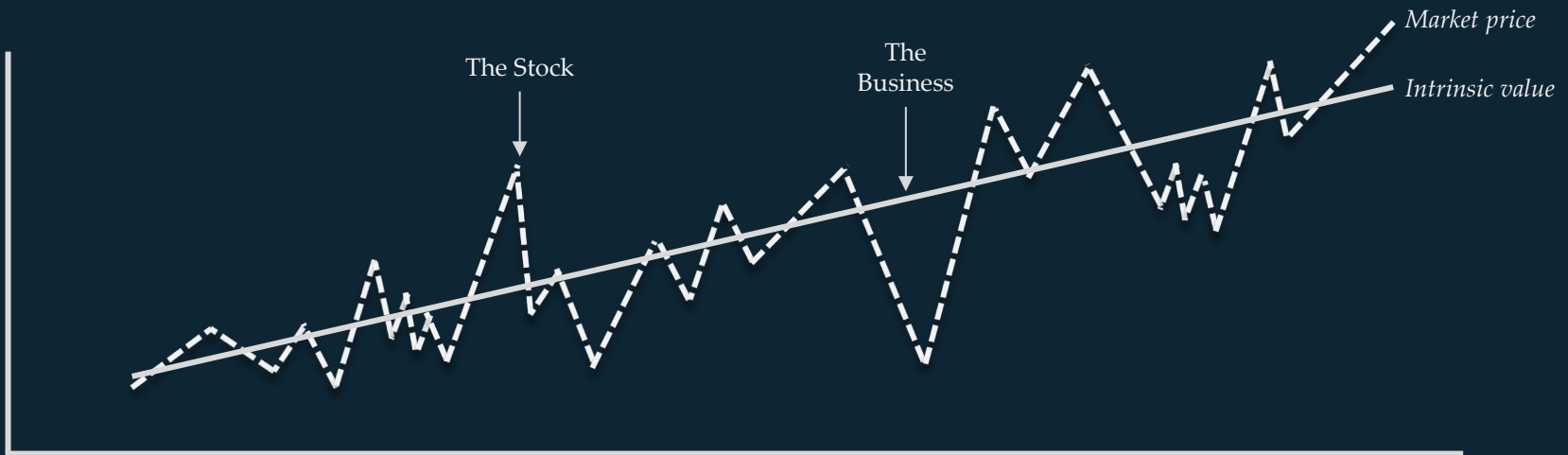


*“Hurray!  
My net worth  
went up!”*

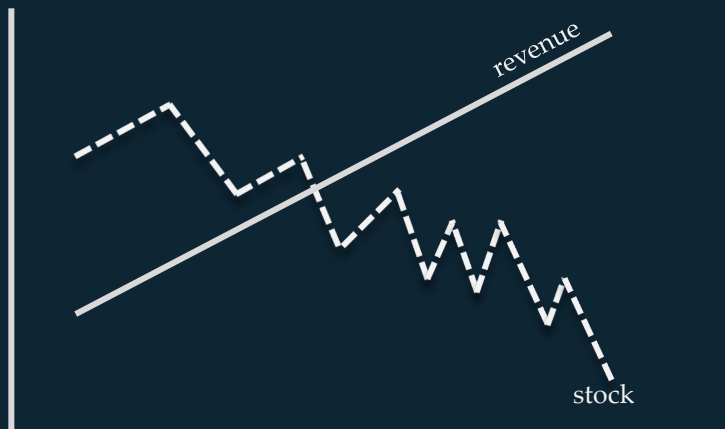


*“Hurray!  
My favorite  
stocks are  
on sale!”*

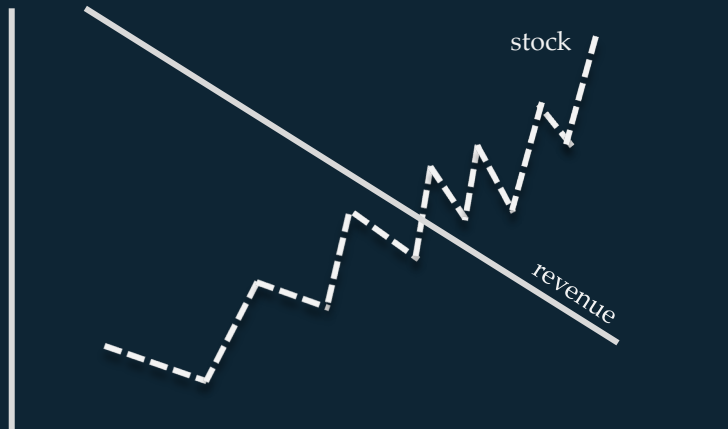
# Know the difference.



Buy damaged stocks.



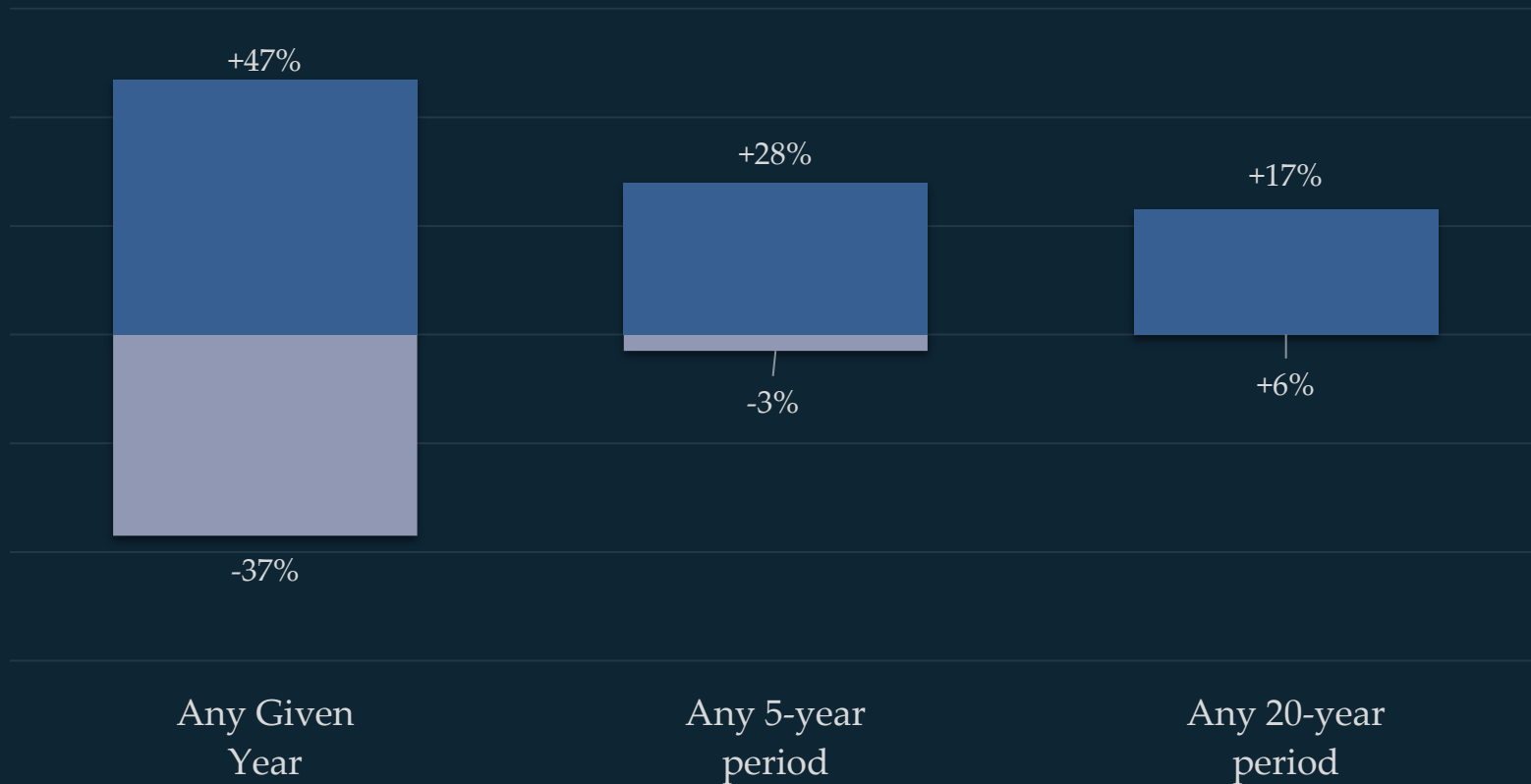
Avoid damaged businesses.





# The fastest way to build wealth is to go slow.

S&P500 total returns (1950-2022) per given period



In closing...

Buy good businesses.

Don't overpay.

Do nothing.