Emotional Influences, Risk Management Behaviour and Impact on participants in the Commodity Markets.

IAOM 2010 Cape Town
25 November 2010

AGENDA

What we have in store today…..

- How to be happier earning less money..
- ……. How to get better looking dates !!
- How you can win free cash !!
- Why the space shuttle challenger should never have taken off !!
- Fight a global disease epidemic…

ALL I ASK IS THAT YOU PARTICIPATE SO WE CAN MAKE THIS FUN !!!

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What is this mumbo-jumbo ?

- There are many definitions of Behavioural Finance ** - It is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets.

- It is of interest because it helps explain ***why*** and ***how*** markets might be inefficient.
- ** As defined by Martin Sewell – University College London

Concept of Relativity

- What if I told you that you were being offered a new job with Big Rains Pty Ltd with a salary of $80,000 ?
- And that all the pay of the people in Big Rains Pty Ltd are paid between $50,000 and $80,000..

- How do you feel as the highest paid person in the company ?

- What if the offer was a little different ? What if you were offered a salary of $90,000 but you knew the range of the people in Big Rains Pty Ltd was from $75,000 to $115,000. Studies have shown that in these situations people are more content in Situation A !!!!

- Your concept of happiness and satisfaction depends on your perception of others.
- Application in Risk Management – does it matter what price another miller has paid for their wheat if you've locked in outstanding margins for your business ?
- "Predictable Irrationality" by Dan Ariely

Sunk-Cost Trap

- We make choices that justify past decisions even when those choices may no longer seem valid.
  - Long/Short Position against us
  - Unsuitable staff-member
- **We know that the sunk costs are IRRELEVANT to the present decision but they are forefront in our minds when we make the next decision and therefore due to that cost, we may make the WRONG one.**

So why….

- Human nature is afraid to admit a mistake
- Public admission of poor judgement is even harder.
- So we stick with the status quo…failure to act is often less punished in a work place than the wrong decision from someone who did stick with the status quo.
- To avoid – Surround your self with “devil’s advocate” types

The Prospect Theory

Daniel Kahneman & Amos Tversky

NOBEL PRIZE 2002 ECONOMIC SCIENCES

Allows one to describe how people make choices in situations where they have to decide between alternatives that involve risk, e.g. in financial decisions

Prospect Theory

- ***AVOIDANCE OF REGRET*** is a primary human motive.
- 2.5 times
- Regret is the emotion experienced for NOT having made the right decision - Is more than the pain of loss. It is the pain of feeling **RESPONSIBLE** for the loss.
- If No Action is taken, feeling responsible is less immediate – keeping the Status Quo.
- **Avoidance of REGRET** is the primary driver in the making of most Non-decisions.
- WE ARE RISK-ADVERSE WITH RESPECT TO GAINS BUT RISK-SEEKING WHEN IT COMES TO LOSSES.

- Imagine I have just given you $1,000 and am offering you either
  - CHOICE A – Receiving another $500
  - CHOICE B – 50/50 chance at another $1,000

- Now consider that I have given you $2,000 and am offering
  - CHOICE C – giving me $500 back
  - CHOICE D – 50/50 chance of giving me $1,000 back or keeping all the money.

From Bank Tellers, Fighter Pilots and the Limits of Rationality by Peter A Ubel

- We usually fail to accurately assess the probability of events – ie we will think more about the probability of a plane crash if there has been a recent one on the news.
- We have undue confidence in the accuracy of our estimations….eg driving
- This over-confidence leads to taking bigger risks than are prudent. Eg Golf
- The primary emotions of risk taking are Hope and Fear NOT Greed and Fear (Hersh Shefrin)

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THE CONCEPT OF ANCHORING

- Anchoring explains how people are influenced when making a decision based on numbers by asking them to think of a high or low number first.
- In Business one of the most common types of ANCHORS is a past event or trend.
- US SSN/Countries in Africa.

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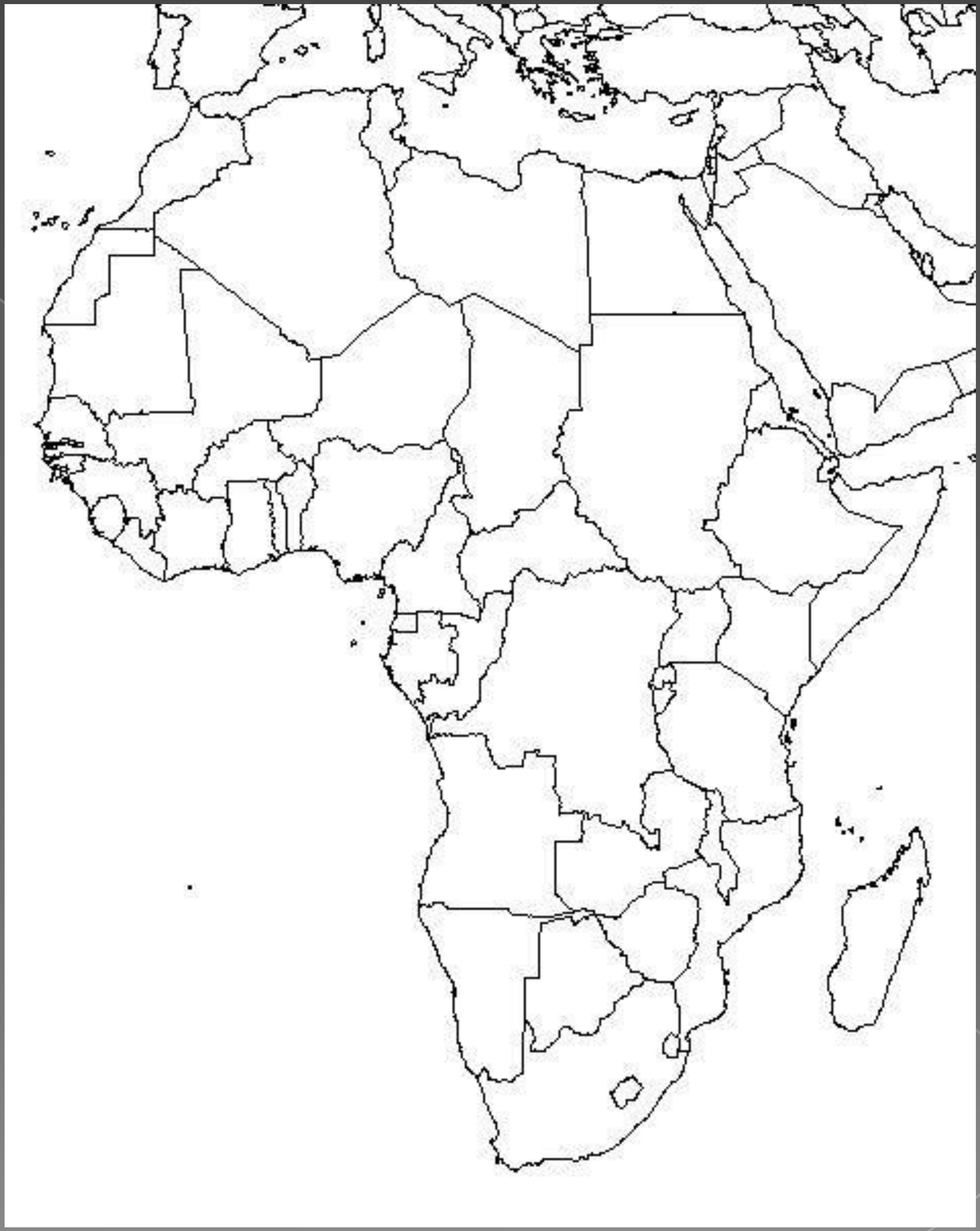

Failure to see or seek Information

- People overlook the information that they are not expecting – and is against their view. Eg Ulric Nasser's video
- They also seek information that supports their view with an un-due weighting.
- Key is to consider very carefully the different angles of a decision and what specific piece of information is leading to that decision. Eg NASA
- To avoid this blinder we should look for information that goes against our view and ask our colleagues to voice contra-opinions

From Decisions without Blinder (HBR)s by Max H. Bazerman and Dolly Chugh.

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FRAMING PROBLEM

- The way a problem is FRAMED, or posed WILL affect the outcome or decision.
- Imagine you are a Doctor…
  - The US is preparing for the outbreak of a disease that will kill 600 people if untreated…
  - TREATMENT A – Will save 200 people
  - TREATMENT B – Has 33% chance of Saving all 600 but 66% chance that no-one will be saved.

- WHICH ONE WOULD YOU CHOOSE ???

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- Now the same problem..with a NEGATIVE FRAME…
  - The US is preparing for the outbreak of a disease that will kill 600 people if untreated…
  - TREATMENT C – Will kill 400 people
  - TREATMENT D – Has 66% chance of all 600 dying and 33% chance all will be saved….

- When Framed positvely –
  - 72% chose A….. Which is the RISK ADVERSE STRATEGY – ie SAVING 200 people
- When Framed negatively –
  - 72% chose D..which is the RISKY STRATEGY..

- **This demonstrates we are <u>risk-averse to gains</u> and <u>risk-seeking to losses</u> and more importantly the <u>way risk management decision is framed can influence the decision taken !!!</u>**

- So how do we apply this to Risk Management and Behaviour in the Markets…
  - **Relativity** – Our concept of good and bad value often pertains to what others have or don’t have
  - **Sunk- Cost Trap** – We are often influenced when making decisions about the $$$/time we have invested in prior “questionable” decisions.
  - **Prospect Theory** – Avoidance of Regret is a strong human driver and often causes us to go with the Status Quo
  - **Failure to See/Seek information** – We look for information that supports our view and ignore information that contradicts it.
  - **Framing Problem** – The way a question is posed to us often influences the decision

What is Risk Management???

Risk Management: *a structured approach*

to managing uncertainty, through

understanding the resources available and

implementing strategies to achieve the

desired results.

Cargill Risk Management

- 1 of the 78 Business Units of Cargill
- 15 years of full dedication in creating tailored products for producers and consumers of commodities to help MANAGE and MITIGATE price risk
- 100+ professionals with global presence
- 10 offices around the world
- 135+ products ready to use and high tailoring degree
- One of the FIRST in the biz and currently Leaders in Price Risk Management in the Commodity world

Why use Experts ?

The True Value of Experience…

System and principles always produce a more predictable outcome and they help remove emotional components'

In terms of understanding a GOOD decision for your business involves understanding your BUSINESS irrespective of the MARKETS !!!

DIVERSIFICATION

DISCIPLINE

CONTROLS

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Diversification

- Don’t put all your eggs in one basket – Like your personal investment portfolio – spread your risks…..

GOLD

EQUITIES

CASH

REAL ESTATE

DISCIPLINE

- NEVER CONFUSE HOPE WITH BELIEF
- MAINTAIN STRICT DISCIPLINE ON TARGETS
- DON'T FALL IN LOVE WITH THE POSITION
- DON'T WAIT FOR THE "EXTRA" US$1
- PROTECT AND ENHANCE YOUR MARGINS

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CONTROLS

- DEVELOP EFFICIENT CONTROLS
- CORRECT SIZING
- REGULAR STRESS TESTING
- CONSTANT MONITORING

Jean Paul Getty

[1892 – 1976]

"In times of rapid change, experience could be your worst enemy."

3 secrets to making money:

- Wake-up early
- Work hard
- **Find Oil**

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At the end of the day, simple things do work…

The Tree!

Thank you for Listening !!!

Contact us at

crm_trinations@cargill.com